Shawbrook Bank

Cebr

The current Buy-to-let market

General assessment and impact of recent policy changes

July 2018

Commercial mortgages

Contents

Compiled by the Centre for Economics and Business Research

Authorship and acknowledgements
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The report does not reflect the views of Shawbrook Bank Limited

London, July 2018

Foreword from Karen Bennett

Following the success of previous reports on the HMO market (2016), and a snapshot of the Private Rented Sector (PRS) (2017), I am delighted to introduce the following piece of research on the current Buy-to-Let (BTL) market, which explores the impact of several recent government and regulatory changes.

Our previous 2017 report, also produced by the Centre for Economics and Business Research (CEBR), mentioned many of the changes that are covered in its 2018 follow up, but at the time of writing the market had not yet felt the impact of these changes. Fast forward to the present day and there has been some marked change to the BTL space and the following pages explore this in more detail.

The issues discussed are ones we have found to be key for professional investors and landlords across the UK, and we have seen the call for more clarity on what this means for a sector that remains a critical component of the UK housing landscape. I believe it delivers a balanced view that not only clarifies the issues faced by todays' professional investor, but also their impact, set against the shifting sands of national political uncertainty which has only served to amplify the challenges faced.

My sincere thanks to the Centre for Economics and Business Research (CEBR) for their work compiling this report and to all other contributors for helping to continue what is a very complex conversation on this sector, the challenges it has faced over the past 18 months, and what the future may hold for BTL.

Yours sincerely,

Karen Bennett
Managing Director
Shawbrook Commercial Mortgages

Foreword.

Executive Summary

In this report, we update our Buy-to-let (BTL) market analysis, and dive deeper into the effects of the changes to stamp duty, mortgage interest tax relief and the tightening of BTL mortgage underwriting rules. We also forecast BTL market activity up to 2023 and compare this forecast with a scenario in which the above mentioned changes were not introduced. This gives us an idea about the magnitude of the effect of these measures. The report concludes by offering an outlook on further challenges and trends in the sector.

The report finds that:

- **After strong growth since the financial crisis until 2015, the number of BTL mortgages for house purchases has dropped over the last two years.** Both the wider slowdown in the housing market as well as a number of government interventions have had an impact on the sector.
- **Demand for privately rented accommodation is expected to increase further in coming years.** Investors need to stay informed about the latest changes, as the BTL sector moves towards further professionalisation and sustainable financial lending practices.
- **In April 2016, the government introduced a 3 percentage point surcharge on stamp duty for second homes and buy-to-let properties.** Transaction levels have fallen sharply after the introduction of the extra levy and have only partially recovered since.
- **The gradual withdrawal of mortgage interest tax relief poses a serious challenge for private landlords with leveraged portfolios.** Industry data show that a rising share of BTL lending goes to limited companies, which are not affected by the tax change, though this is by no means a straight-forward solution for everyone.
- **The Prudential Regulation Authority introduced a stricter affordability test for BTL borrowers and mandated that lenders have specialised underwriting processes in place for portfolio landlords with four or more properties.** This will likely lead to a further professionalisation in the sector. At the same time lenders have to keep up with the regulatory changes which means that underwriting for BTL loans has become a more individualised process.
- **The changes in tax rules and underwriting standards have impacted the BTL market via their effects on transaction costs, landlord demand and access to finance.** Using a scenario analysis approach, we estimate that by 2023, up to 360,000 fewer BTL mortgages will be approved due to the changes.
- **The effect on house prices is expected to be relatively small, while rental yields would likely be lower if the tax changes had not been introduced**, given that a lack of BTL properties should drive up rents.
- **The regional focus of BTL activity is shifting away from London as the capital suffers from limited prospects both for yields and house price growth.** The North West region and Manchester in particular are frequently mentioned as new investment hotspots. Lower property prices mean that it is easier to achieve decent rental yields and the city is attracting students and employees from all around the country.

Introduction

In February 2017, the Centre for Economics and Business Research (Cebr) produced a report for Shawbrook Bank examining the state of the Buy-to-let (BTL) market, which at the time was undergoing substantial changes in a number of areas. On the back of the increasing share of UK households living in privately rented accommodation, the BTL sector grew substantially since the early 2000s. Many private investors flocked into property as an attractive asset class backed by the seemingly unstoppable rise of UK house prices. This has put the BTL sector in the spotlight and subjected it to much closer scrutiny resulting in a number of legislative changes with the aim of professionalising the sector, promoting sustainable lending practices and to free up housing supply for first-time buyers. The main changes were threefold:

- Changes in mortgage tax relief
- Changes in Stamp Duty on second homes
- Tightening of underwriting standards for BTL mortgages

Now, more than one year later our report will give an update on how these changes have affected the BTL market and discuss the current state-of-play. The report will further include a quantitative exercise, estimating the impact of the above listed policy changes on market activity, rental yields as well as on house prices. We will do so by forecasting these indicators until 2023 and comparing them with a hypothetical scenario under which the changes in the tax system and underwriting standards were never implemented.

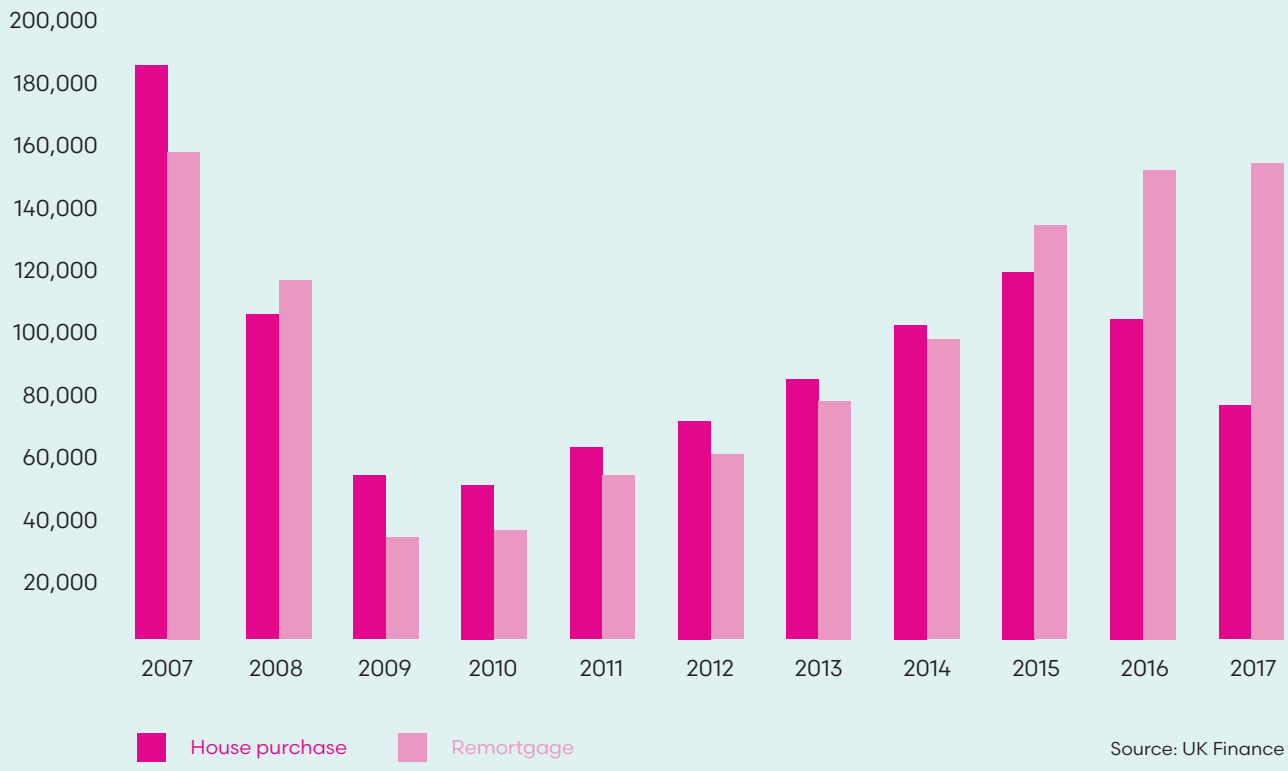
Ultimately, the report will take a look ahead, examining the most pressing issues for current and future BTL landlords. The potential impact of Brexit on the sector will be examined as well as the changing landscape for amateur and professional landlords and the changing regional trends in the BTL market.

2. The current Buy-to-let market

The Buy-to-let sector has undergone some drastic changes in recent years which have had a material effect on demand for BTL properties and related mortgage products. Policymakers have changed a number of key factors mostly aimed at making the BTL sector less profitable for private investors and moving it towards greater professionalisation. As can be seen in Figure 1, the BTL sector increased rapidly in the wake of the financial crisis with the number of BTL mortgages approved almost doubling within five years. Between 2011 and 2015 the number of mortgages rose from 62,000 to 118,000, a figure last exceeded in 2007.

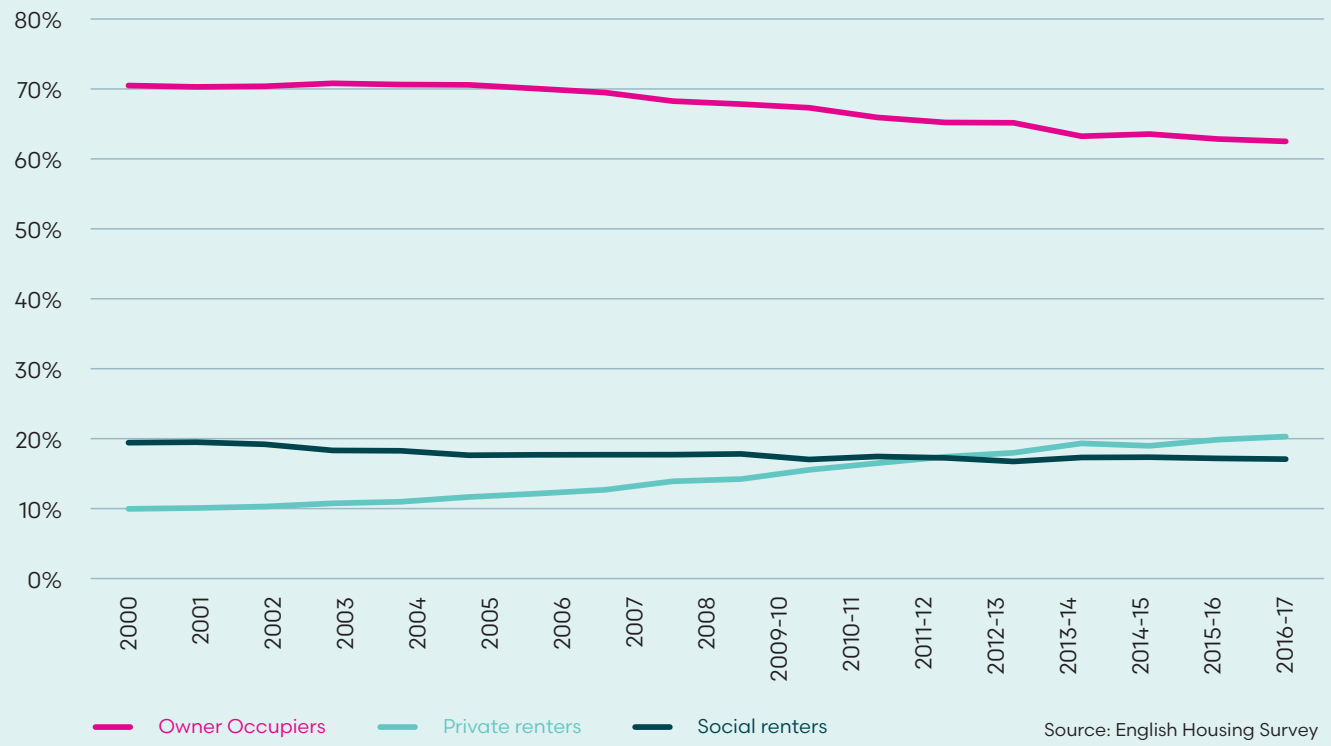
The reasons for this growth spurt are diverse and interconnected. The increase in the number of BTL mortgages is closely related to the rising importance of the private rented sector. The share of households living in the PRS has been relatively stable for decades, varying between 9% and 11% from the 1980s to the early 2000s. In the past 15 years however, this share has doubled to over 20% in 2016-17 according to the latest data from the English Housing Survey as both the share of owner occupiers and households in social rent declined. This has been both the result of a change in preferences as well as the consequence of the increasing unaffordability of housing for large parts of the population.

Figure 1
Number of new Buy-to-let mortgages



Source: UK Finance

Figure 2
Trends in Housing Tenure



Younger households might prefer rented accommodation to home ownership as it allows for greater flexibility. Similarly, migrant households are more likely to be in the PRS in the first years after arrival before deciding whether or not to stay in the UK in the longer term. Simultaneously, the very strong increases in house prices over this period in combination with low average wage growth have made it increasingly difficult for large parts of the population to get a foot onto the housing ladder. Reckless lending practices in the run-up to the financial crisis have further weighed on numerous households with large debt burdens that they struggle to repay. After the recession, banks have significantly tightened their lending standards and products such as interest-only mortgages and high loan-to-value mortgages are harder to come by. Because many households have not been able to save up the required money for a deposit the share of individuals and families staying in the PRS for a longer time has increased.

Furthermore, the ultra-low interest rates following the financial crisis have made property as an asset class comparatively more attractive for private investors. Apart from the rental yield, investors further valued the opportunity of seeing substantial capital increases in their properties making it a seemingly safe bet, thereby creating further demand for BTL properties.

After this period of sustained growth following the financial crisis, the number of BTL mortgages for house purchases dropped in 2016 by 13%, followed by an even steeper fall of 27% recorded in 2017. This suggests that the various changes in the BTL sector have had a significant effect on demand for such properties.

"We are seeing a potential shift in strategy in the shape of investors and landlords holding stock rather than purchasing anything new, focusing instead on driving yield. A politically uncertain environment has exacerbated what is an already cooling market, and we have also seen a rise in the amount of development and bridging finance, with the investor profile moving to one geared more toward adding and creating value (e.g. "build to rent") rather than outright purchase activity centred around capital uplift."

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The current Buy-to-let market continued

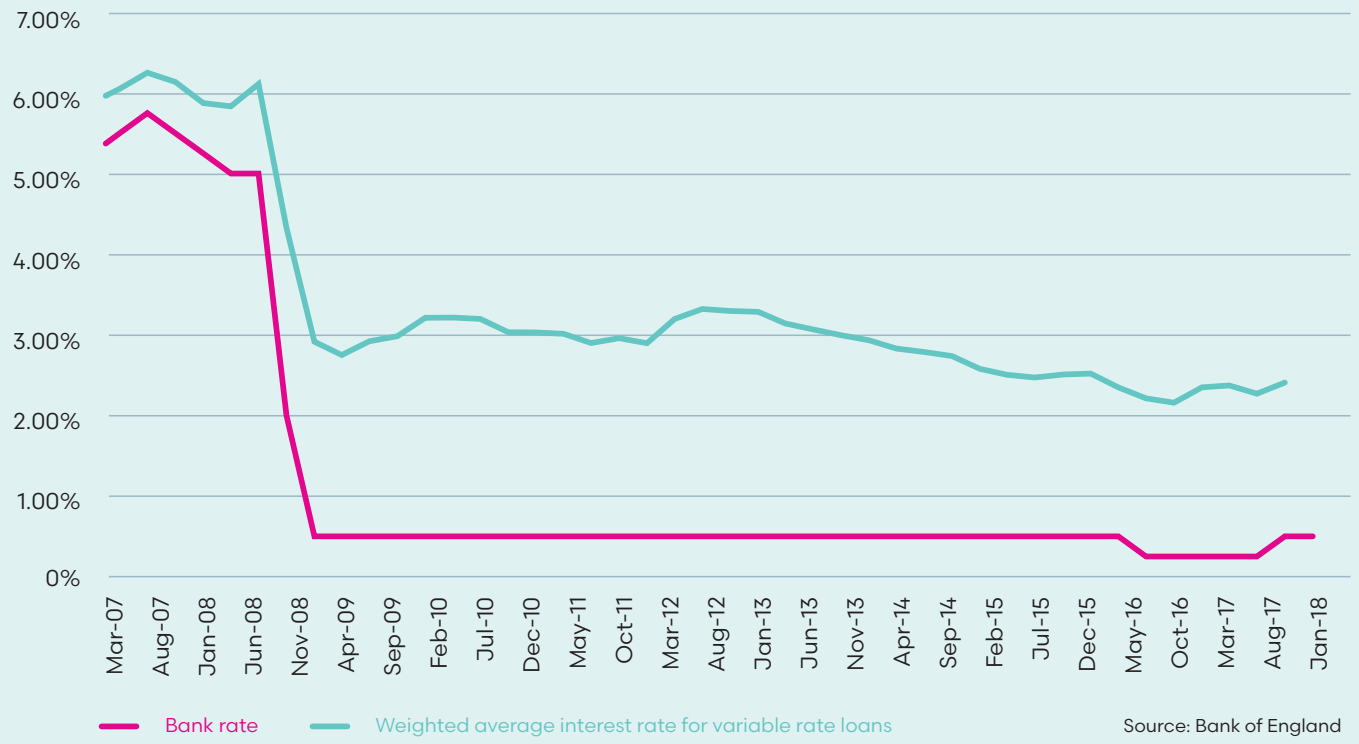
2.1 Remortgaging trends

Figure 1 also shows that since 2009 the number of individuals remortgaging their BTL property has increased at an even faster rate than the number of new purchases. A decade after the start of the financial crisis, levels of remortgaging have nearly caught up again, standing at 152,000, just shy of the 156,000 recorded in 2007. There are two main motivations for remortgaging. Low interest rates have clearly incentivised landlords to remortgage their properties in order to decrease their monthly payments. Other landlords want to release equity from their properties, which can be a sensible move if the borrower has repaid a significant amount of the outstanding capital. The released equity might then be used to buy further properties in cash to avoid some of the new regulations.

As can be seen in Figure 3, the Bank of England cut interest rates to 0.5% during the financial crisis to assist the lending mechanism in the economy and prevent an even more severe economic slowdown. This had a direct and clear effect on mortgage rates as shown by the weighted average interest rate for variable rate mortgages, which fell to around 3%. Following the referendum result in June 2016, the Bank of England cut interest rates again to 0.25% pushing variable loan rates towards 2%. The graph shows that borrowers on variable rate loans had a substantial incentive to remortgage even long after the BoE cut rates to 0.5%. Variable rates fell by 27% between Q3 2012 and Q4 2017. As a result, remortgaging has seen an impressive boom, though growth has slowed to just 1% in 2017, indicating that the slowdown in the sector also weighs on the number of borrowers who remortgage.

Figure 3

Bank of England, bank rate and weighted average interest rate for variable loans, in %



Source: Bank of England

As the BoE is expected to lift interest rates this year, we expect to see a last uptick in the number of remortgages as borrowers try to lock in cheaper rates in early 2018 before we expect that figure will start to decrease in line with the number of mortgages for new purchases. The extent of this of course depends on the pace of monetary tightening by the BoE. While it still remains possible that we see two rate rises in 2018 and 2019 each, the BoE is keen to stress that its Monetary Policy Committee is closely watching the relevant economic indicators and might decide to slow the pace of tightening if it sees fit. Along the same line, a stronger than expected economy with fast rising wages would compel the BoE to accelerate interest rate rises. The sustainability of the BTL market depends on landlords being prepared for either scenario. As a protection against fast rising interest rate rises, many landlords are taking out fixed-rate loans. In fact, as shown by Figure 4 (overleaf) the share of fixed rate mortgages has increased substantially over the previous years, rising from a low of 37% in Q1 2010 to 90% in Q4 2017.

" Investors are increasingly looking at incorporating to build more tax efficient structures which would have a marked effect on re-mortgage activity. In addition, the last few years have seen a fairly buoyant market with investors building significant equity upon which they are now seeking to capitalise. We have also seen historically low rates, encouraging investors to use a low-cost leveraged model whilst maintaining a healthy yield, with the popularity of 5yr fixed rates increasing."

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The current Buy-to-let market continued

For the BTL sector, fixed rate mortgages have become especially attractive after the recent regulatory changes. This is due to the fact that borrowers who take out a five-year fixed rate mortgage do not need to undergo a so-called stress-test – a simulation of their repayment situation under significantly higher interest rates. This makes a five-year fixed rate mortgage attractive for many landlords who want to either simplify their application process or who might think they would struggle to pass the stress test. The overall increase in the share of fixed-rate mortgages (across all types of mortgage lending) suggest this has already been happening.

"With the PRA changes now in place, the 5-year fixed option allows investors to leverage at a slightly higher level and combine this with the certainty of a fixed cost over this period."

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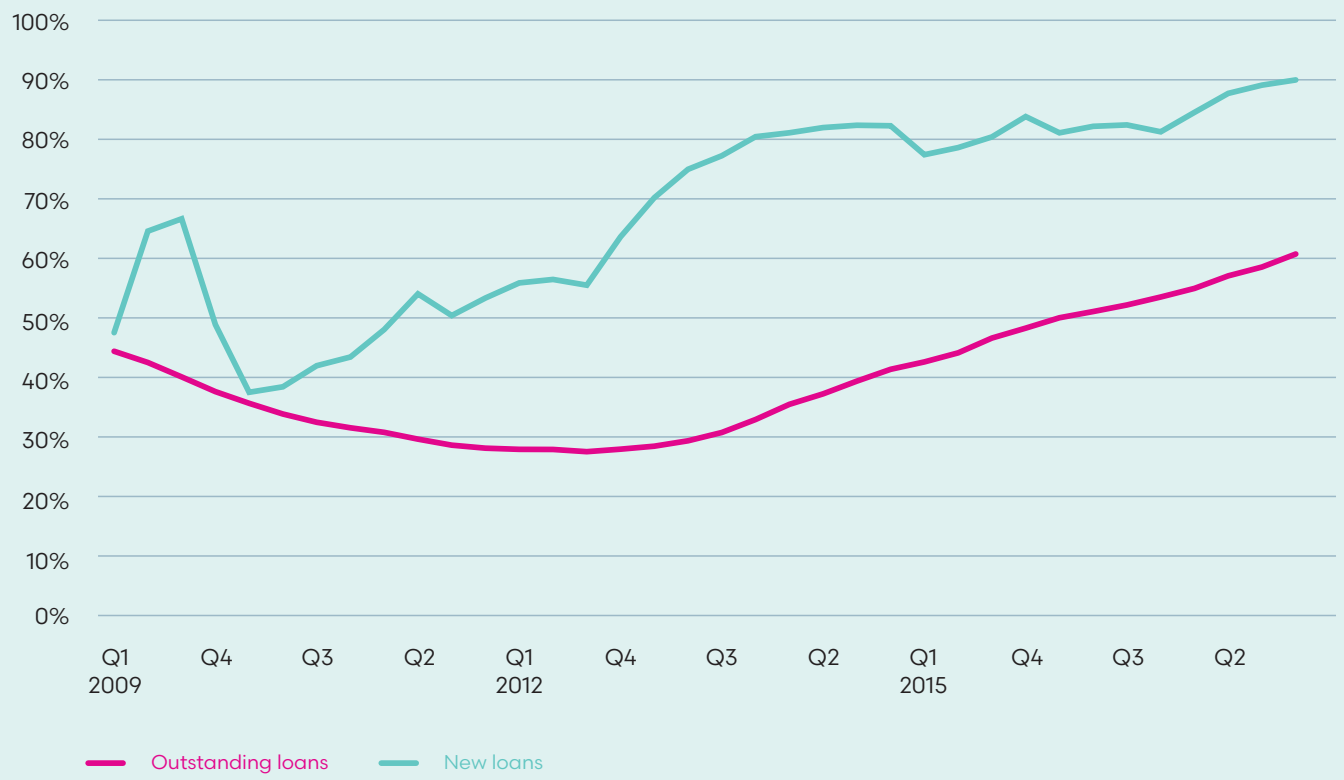
Figure 4
% of mortgages on fixed rates



Source: Bank of England via Macrobond, Cebr analysis Includes all types of mortgage lending

2.2 Changes in Stamp Duty on second homes

We now turn to a brief discussion of the recent changes the BTL sector has undergone and the effects on the market. The 2016 fall in BTL activity pictured in Figure 1 coincides with one of the most severe changes in the tax code affecting the BTL sector: the introduction of an additional 3 percentage point surcharge on the purchase of a second home which came into effect on 1 April 2016. By definition this surcharge applies to BTL properties and increases transaction costs. The surcharge is applied on top of the regular rate of Stamp Duty Land Tax, which ranges from 2% for properties worth up to £250,000 up to 12% for properties worth over £1.5 million.[1]

As an example, the SDLT for a property worth £275,000 currently stands at £3,750 if it is the only property owned by the buyer. If it is a second or BTL property, the tax bill goes up to £12,000, an increase of 220%. Table 1 demonstrates the calculations for SDLT under the two different scenarios, showing the increase for the various amounts in each price band if the property will be used as an additional residential property. For more expensive properties, the 3 percentage point surcharge results in even bigger increases in the tax bills in absolute terms. For example, for a property priced at £500,000,the tax bill jumps from £15,000 to £30,000; for a property valued at £2 million, a potential buyer would need to come up with £213,750 for the SDLT bill if the property is a second residence, a difference of £60,000 compared to the £153,750 under the regular regime.

Table 1
Stamp Duty Land Tax calculations

Purchase price: £275,000	Tax on only property		Tax on second properties	
Purchase price bands (£)	**Percentage rate (%)**	**SDLT due**	**Percentage rate (%)**	**SDLT Due**
Up to 125,000	0	£0	3	£3,750
Above 125,000 and up to 250,000	2	£2,500	5	£6,250
Above 250,000 and up to 925,000	5	£1,250	8	£2,000
Above 925,000 and up to 1,500,000	10	£0	13	£0
Above 1,500,000+	12	£0	15	£0
Total SDLT due		**£3,750**		**£12,000**

[1] Buyers don't pay SDLT on the first £125,000 of the property price. Properties values at below £125,000 are therefore practically exempt from SDLT.
Source: gov.uk

The current Buy-to-let market continued

Effects on transaction costs

Unsurprisingly, the introduction of the stamp duty surcharge on second homes had a significant and lasting effect on the BTL sector. Figure 5 shows the share of BTL mortgages among all new advances. In line with the data seen in Figure 1, the share of BTL mortgages increased after the financial crisis, rising from 5% in Q3 2009 to 16% in Q4 2015 as private investors flocked into the BTL sector. Most notably in the graph below, however, is the spike in Q1 2016, where the BTL share of all new advances jumps to 21% before falling back to 14% in Q2 2016. This is clearly a result of the introduction of the stamp duty surcharge in April 2016, which led a large number of BTL investors to move the purchase date forward to avoid the extra levy. After a small and temporary increase to 15% in Q1 2017, the share has fallen further to 13% over the following three quarters of the year reaching its lowest level in more than four years.

Interestingly, we see a significant uptick in BTL lending in Q3 2017, when BTL advances increase from £8.1 billion to £9.1 billion in absolute terms. Though various factors could be at play, the introduction of tougher underwriting standards for portfolio landlords in September 2017 could have led to a rush of borrowers who wanted to secure financing ahead of the new regulations. Another potential factor explaining the overall increase in the volume of total advances is the interest rate rise by the Bank of England in Q4 2017.

The 2016 fall in BTL transaction levels coincides with – and in fact has likely been caused by – the introduction of the 3 percentage point stamp duty surcharge for BTL property in April of that year. Basic economic theory suggests that as transaction costs increases the number of sales taking place will decrease. A certain number of transactions that might have been just about profitable for both parties before the introduction of the stamp duty surcharge have been rendered financially unprofitable through the surcharge thereby depressing the number of sales.

Furthermore, investors will think twice before making another move in the market as any future sale of a property would again incur the tax – meaning they might not achieve the price they hope to when selling the property on. The extra levy hits individual and professional landlords alike, but is naturally more of a concern for those operating on slimmer margins of profitability and those who buy and sell properties more frequently. As shown in Figure 5, BTL landlords reacted to the introduction of the tax by bringing forward a substantial number of transactions. However, nearly two years after the introduction of the extra levy transaction levels are still far lower than those seen prior to April 2016. This contrasts with the wider housing market, where transaction levels have seen a similar distortion around the date of the introduction of the tax but have since mostly recovered. This highlights the changed realities in the BTL sector after the introduction of the SDLT surcharge – the extra levy has increased purchasing costs significantly. It is important to stress, however, that while the Q1 2016 spike in BTL activity can be attributed almost exclusively to the introduction of the extra levy, the ongoing slump in the sector is likely the result of various factors and changed market conditions.

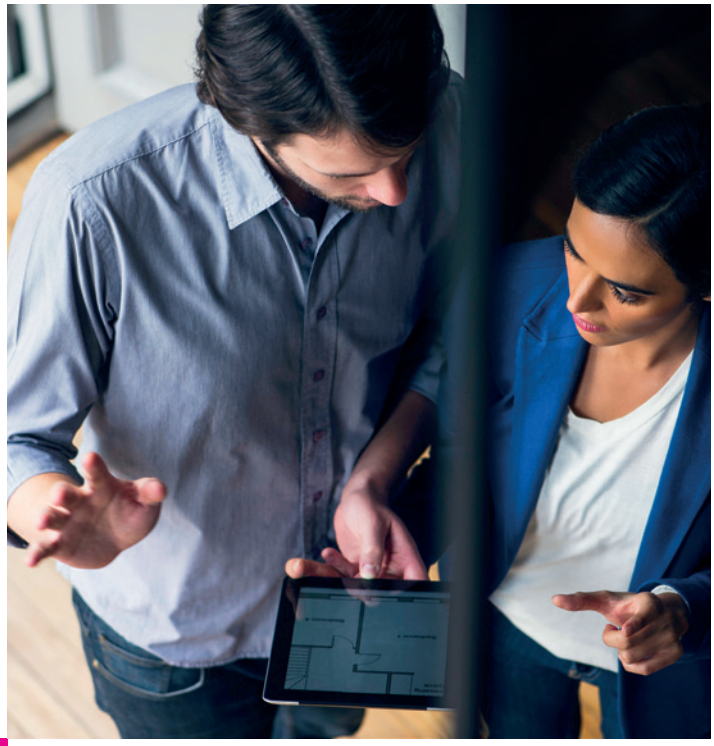
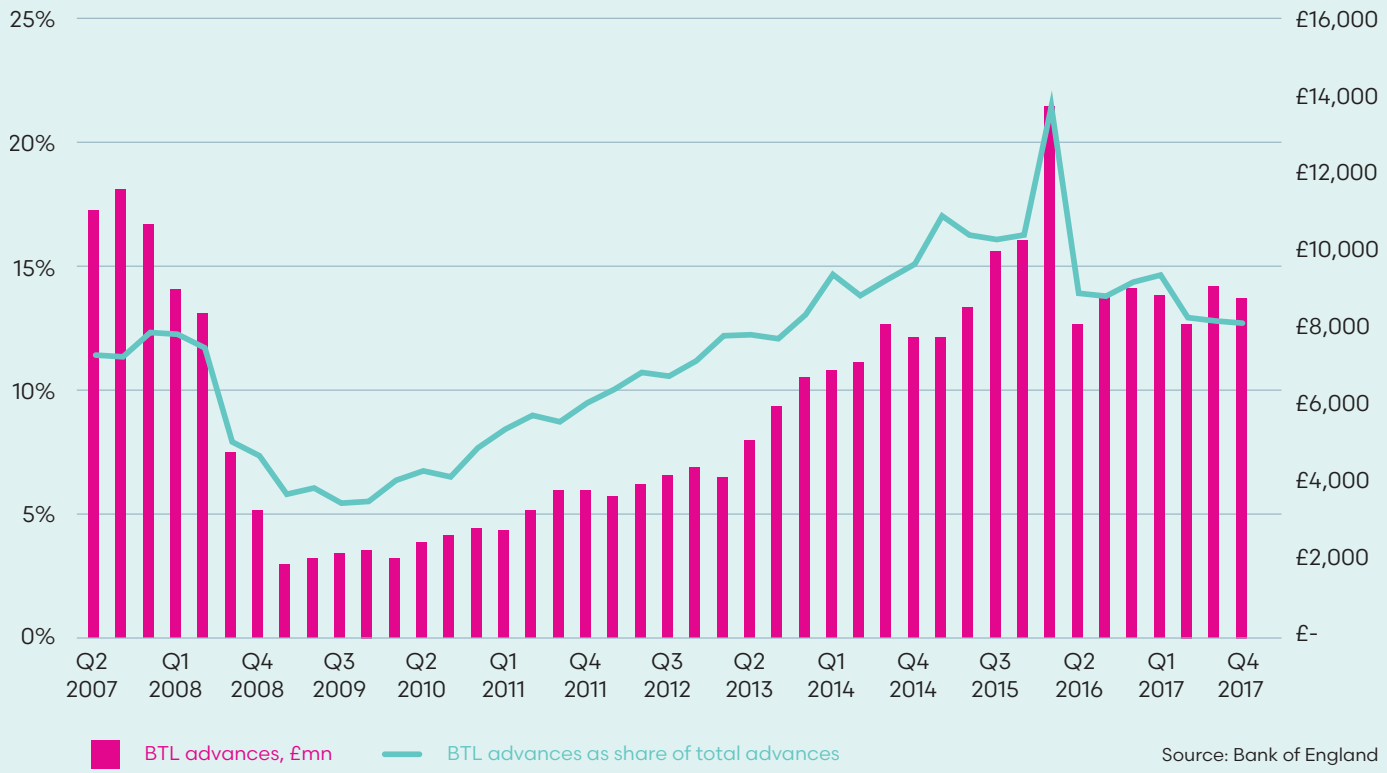


Figure 5
BTL mortgages (excluding remortgaging), in £mn and as share of total advances



Source: Bank of England

" There are several factors at play including, more broadly, the spectre of Brexit and what this means for the economic landscape. We have seen a raft of regulatory and government change contributing to the turbulence experienced by the BTL space, including a shifting tax regime and the various changes made by the PRA with regard to affordability and the portfolio space. A significant consequence of this has been what some have dubbed the "professionalisation of BTL" with smaller investors looking at other asset classes for investment opportunity. Whilst there has been a slump, the outlook remains fairly positive when compared to Q4 2014."

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2.3 Changes in mortgage interest tax relief

A further significant change in the BTL sector concerns the tax deductibility of mortgage interest payments. Prior to April 2017, Buy-to-let landlords were able to deduct the full cost of mortgage interest payments from their tax bill, increasing the viability of many BTL investments from a tax point of view.

From April 2017, Buy-to-let landlords can no longer deduct the full cost of their mortgage interest payments from their tax bill. The available deduction will be gradually reduced until 2020, leaving private landlords with a 20% flat rate relief. Since interest costs will no longer be deducted for tax purposes, many private investors will see their tax bill increase substantially.

The full tax deductibility of mortgage interest payments meant that in practice, landlords would pay tax on their profit from the BTL investment, i.e. rental income less mortgage costs. The new rules, which are being gradually phased in since last year, restrict the tax relief on financing and shift the tax base from the net profit to gross income. From April 2020 on, the tax relief will be restricted to the basic rate tax reduction, currently standing at 20%.

The stated policy objective of the change in the tax code is to make the system fairer ensuring that landlords with higher incomes no longer receive the most generous tax treatment'.[2] However, as a consequence of this change many higher-rate paying BTL landlords will see the profitability of their investment decrease substantially.

As shown in Figure 6, a private landlord with a rental income of £5,000 per month and mortgage interest costs of £4,000 per month would be left with an after-tax profit of £600 according to the old tax rules, assuming the landlord pays 40% income tax on the net profit of £1,000. Once the changes are fully implemented in 2020, the same landlord would make a loss of £200 per month as the tax bill would rise from £400 to £1,200, exceeding the pre-tax profit. The changes will replace the full deductibility of mortgage interest rates with a flat rate rebate of 20%. This means the landlord needs to pay 40% income tax on the gross rental income of £5,000, amounting to £2,000, less £800 resulting from the 20% rebate of the £4,000 mortgage interest paid.

Generally, for higher rate tax payers BTL investments will become lossmaking if their mortgage interest cost is 75% of rental income or more.

Figure 6

Pre-tax profits, taxes and net profits under the new mortgage interest tax regime, private landlords

Source: UK Finance

Effects on landlord demand

The withdrawal of mortgage interest tax relief is a serious threat for a large number of leveraged landlords and we therefore expect demand for BTL mortgages to fall further over the coming years. The preferential tax treatment of BTL investments has made it a coveted space for individuals who believed in the stable returns of the housing market. However, as demonstrated in the chapter above, the withdrawal of the tax relief has the potential of turning profitable investments into loss-makers, especially for highly leveraged higher rate taxpayers. Given that the changes in the tax code are rolled out only gradually, we expect the full effect on landlord demand to materialise in the coming years. In 2019 when landlords will need to fill in their tax returns for the financial year of 2017-18, many might become aware of these changes for the first time. The potential consequences for landlords are further exacerbated by the fact that many private landlords are still unaware of the changes to their mortgage tax relief. These landlords could both be 'accidental' landlords, who rent out a property without considering themselves a 'BTL investor' as well as other small scale landlords who do not keep up with the latest changes in tax codes. This could lead to some unpleasant surprises in 2019 when landlords need to fill in their tax returns for the financial year to April 2018, which is the first year with the changed mortgage interest tax relief.

Looking ahead, two factors will affect profitability for private BTL landlords beyond tax changes: rental growth and the path of interest rates. According to the ONS' Experimental index of private housing rental prices, rents have increased by 1.1% in the 12 months to February, well below the general rate of inflation. Rental growth has been especially weak in London, the North East and Scotland. If these trends persist, landlords will have little scope to raise rents by much more than the local average without losing tenants, limiting their ability to react to the changes in the tax code by raising rents. At the same time, the Bank of England has hinted strongly at upcoming rate rises in their latest communications which increase borrowing costs. Increasing mortgage interest rate costs would further put private landlords under pressure.

" The introduction of section 24 has made investors review their existing model and investment strategy, seeking additional specialist advice prior to growing further, and our own additional research suggests that more investors are looking to professional mortgage brokers for assistance. This has led to more focus on strategic moves such as the shift towards incorporation, and identifying more yield opportunities in the shape of other security types (HMOs/ Multi-lets). The full impact of the tax changes is yet to be felt and we expect investors to continue to adopt a "wait and see" approach until their tax position crystallises."

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[2] Retrieved from https://www.gov.uk/government/publications/restricting-finance-cost-relief-for-individuallandlords/restricting-finance-cost-relief-for-individual-landlords

The current Buy-to-let market continued

2.4 Tightening of underwriting standards for BTL mortgages

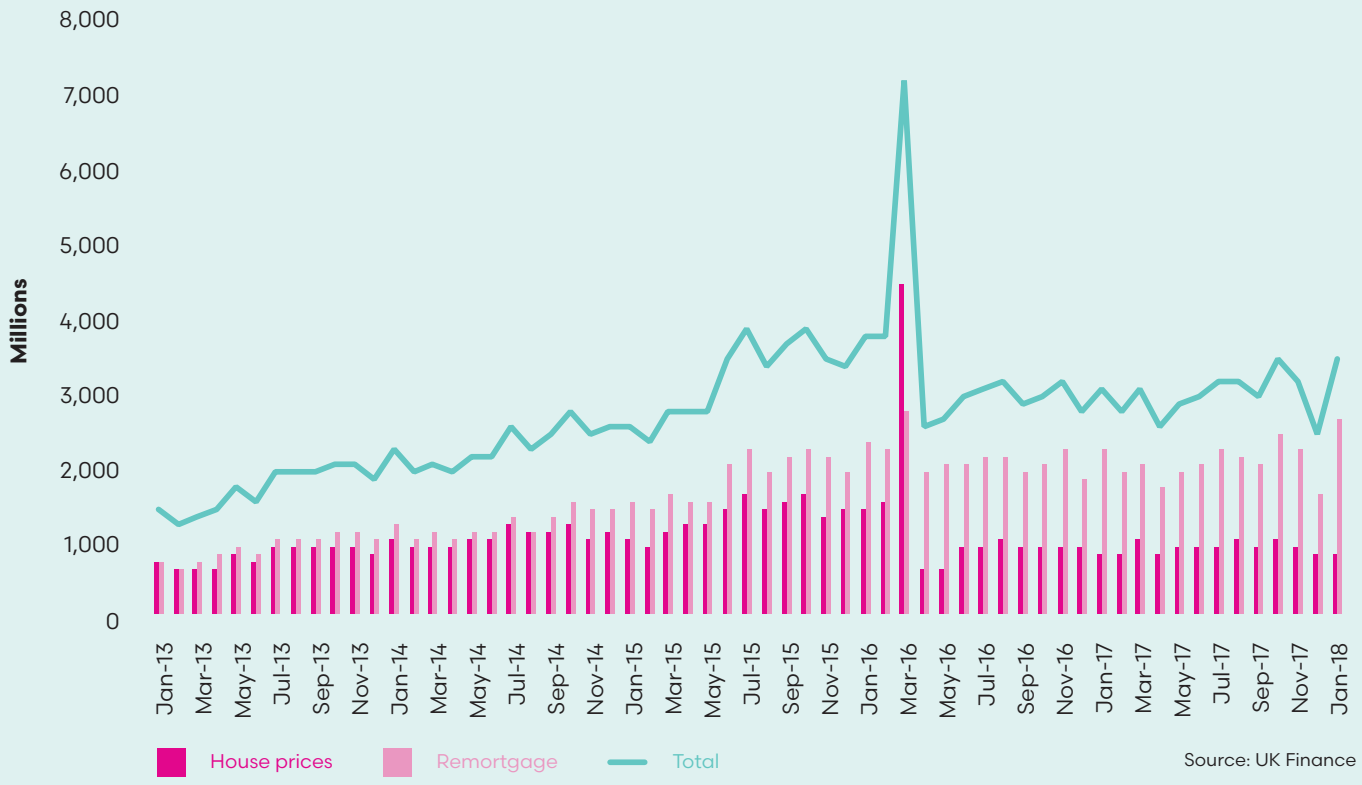
On top of higher stamp duty for BTL properties and the abolition of the mortgage tax relief, potential borrowers also have to undergo stricter affordability testing following a tightening of underwriting rules by the Bank of England's Prudential Regulation Authority (PRA). The first set of changes came into effect in January 2017 and set out that lenders had to check much more closely whether a borrower would be able to afford the mortgage. Lenders now need to check that the mortgage is affordable either through an interest coverage ratio (ICR) test or through an income affordability test.

The former examines whether the income generated from the property is sufficient to cover the monthly mortgage costs including other related fees such as management and letting fees, council tax, service charge, insurance, repairs, voids, utilities, gas and electrical certificates, licence fee, ground rent and any other costs associated with renting out the property. The income affordability test is applied in case the borrower would use personal income as well as rental income generated from the property to pay off the mortgage. This test aims to give a realistic picture of the potential borrower's income as well as the borrower's credit commitments, essential expenditure and living costs.

In addition, potential borrowers need to pass an interest rate stress test, assuming a minimum borrower interest rate of 5.5% over the first five years and taking into account the impact of any likely future interest rate rises. As a result, the checks that lenders have to perform on potential borrowers are much more detailed and individualised compared to previous years. This has led to a situation where detailed specialist knowledge from mortgage brokers has become essential with automated processes often failing to adequately combine and interpret the various sources of information.

This also holds true for the more stringent underwriting rules for portfolio landlords, which came into effect at the end of September 2017. Landlords with four or more properties will need to pass a specialised underwriting process. The regulator aims to mitigate the elevated risks from these landlords resulting from the higher aggregate debt levels, more complex cash flows and cost structures and geographical concentration of properties. Under the new rules lenders need to take into account the borrower's experience in the BTL market segment and their full portfolio of properties and mortgages as well as an overview of total assets and liabilities (including tax liabilities). A cash flow analysis needs to be part of the borrower's assessment as well as a business plan analysis which examines whether or not adding further properties to the portfolio makes sense. As a consequence lending costs are likely to increase. Bigger, established banks have also partially reacted by reducing their Buy-to-let offer resulting in less choice for portfolio landlords.

Figure 7
Value of new BTL lending



Source: UK Finance

Given the tightened underwriting standards, it might become much harder for potential borrowers to get the required funding. Those who are not able to convincingly make the case in their loan application or those who fail one of the increasingly complex affordability tests might be offered a smaller loan than they had hoped for or in more severe cases be denied a loan altogether. It becomes therefore more important to seek out knowledgeable and qualified lenders, who can help to navigate the application process. Another option worth considering for borrowers is to take out a five-year fixed mortgage which eliminates the need for interest rate stress testing.

The exact impact of the new underwriting standards on BTL market activity is hard to quantify, but it is reasonable to assume that by making it harder to obtain the necessary financing for an investment, the new rules likely contribute to the overall slowdown.

3. Impact of BTL changes on the market outlook

Having outlined the recent and most important tax changes for the BTL sector in the previous chapter, we now turn to an analysis that quantifies the likely impact of these changes. In order to illustrate these changes we also present a five year forecast. The approach used in this chapter is a scenario-based one, which aims to answer the hypothetical question of what would have happened to the BTL sector if the reforms mentioned previously were not implemented. Since the BTL sector is closely intertwined with the wider housing market, it is not always possible to establish a direct causal relationship between any one specific policy and a market indicator, e.g. house prices or rental yields. However, based on our internal housing models and our best judgement we have developed a number of assumptions that paint a realistic picture of the counterfactual scenario. The following chapter will outline the results of the scenario analysis and our forecast for the following three indicators: BTL activity, house prices and rental yields.

3.1 BTL activity

Buy-to-let market activity is certainly one of the central indicators to look at when evaluating the BTL sector performance over the last year as well as the impact of the government's various policy interventions described in the previous chapter. As shown in Figure 1, the number of BTL mortgages decreased sharply in 2016 and 2017, falling from a multi-year high of 117,500 mortgages given out in 2015 to 74,900 in 2017, a two-year drop of 36%. In this section we analyse how the recent regulatory and tax changes have influenced BTL activity over recent years and how we see market trends evolving going forward.

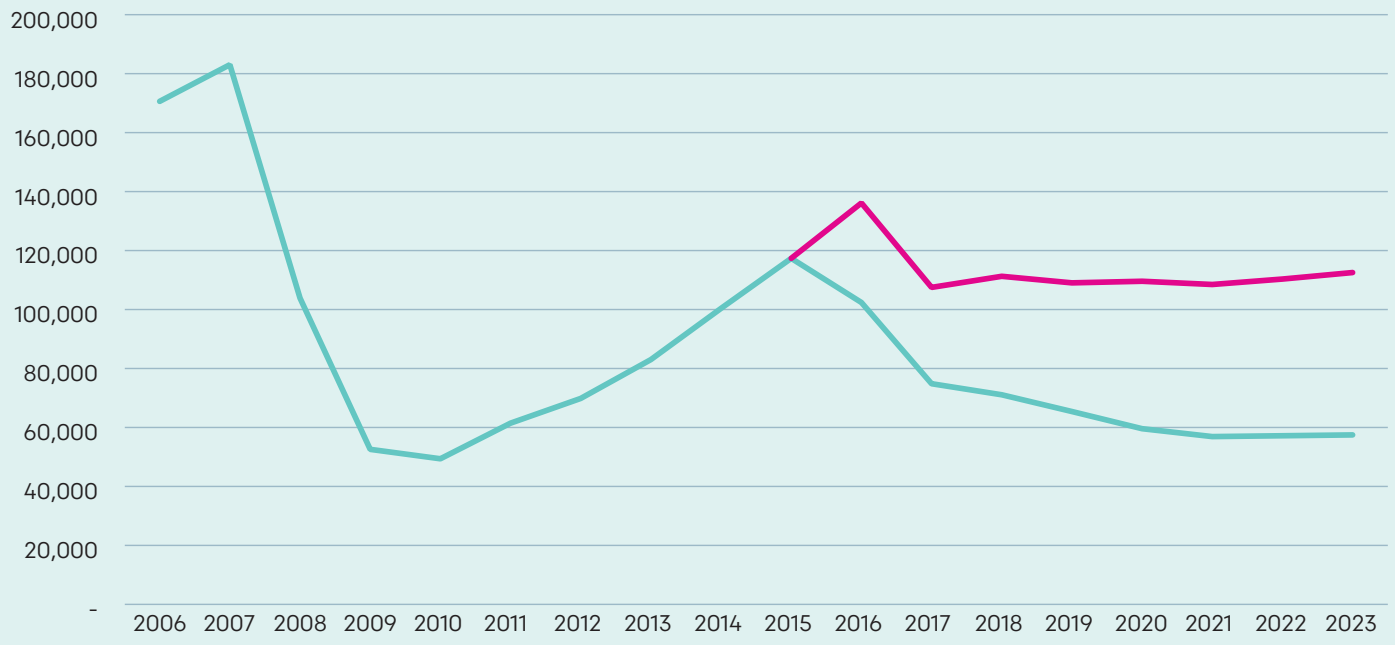
Scenario analysis

Based on the historical relationship between BTL market activity and lending volumes in the wider housing market and keeping in mind the above analysis, we have forecast mortgage numbers for the next five years, shown in Figure 8 as the central scenario. The data until 2017 are taken from the Council for Mortgage Lenders and include the steep drop in lending activity in 2016 and 2017. The graph shows further contractions in every year until 2021 when the market stabilises and mortgage approvals grow by half a percent in the following two years. However, having reacted to the initial changes brought about by the increase in stamp duty and the withdrawal of mortgage tax relief, we expect the market to fall by less than in the previous two years. Given strong demand for private rental accommodation and a 'core' of professional landlords (either as individuals or limited companies) the market is bound to hit a floor in the near future. It is further important to note that this analysis is conditional on a relatively smooth transition as the UK leaves the European Union. Major upsets during the transition period from 2019 to 2021 could easily have serious consequences for the housing market which would also affect the BTL sector.

The pink line in Figure 8 represents a counterfactual scenario, i.e. this is a hypothetical scenario where the government has not introduced the stamp duty surcharge, is not withdrawing mortgage interest tax relief and the PRA has not tightened underwriting standards. As this is a state of the world that does not exist and can therefore not be observed, we have had to rely on our experience and expertise to come to the assumptions underlying this scenario. As can be seen, under the counterfactual scenario we expect the BTL market to have grown further in 2016. Given the strong performance in previous years, a healthy housing market in that year and robust demand for PRS housing, the BTL sector would have found 2016 to be an excellent year for further growth. However, it is also obvious that the government interventions in the market cannot be made solely responsible for the slowdown seen in the market over the last couple of years. For this reasons our model shows that a correction in the market in 2017 would have led to a decrease in BTL mortgage approvals from 136,500 in the previous year to 111,400. Last year was a difficult one for the housing market, with a lot of the downward pressure on prices emerging from London and the South East, which suffer from an oversupply of high-priced properties that the market struggles to absorb. Brexit has become more of a topic as details about the complicated negotiations between the UK and the EU emerged. Going forward we would expect BTL mortgage approvals to be much more stable compared to the central scenario with moderate growth expect for most years until 2023. As a result, the difference in BTL mortgages between the central and the counterfactual scenarios between 2016 and 2023 adds up to around 360,000 more mortgages that could have been added if the changes to the tax system and underwriting process had not occurred.

Figure 8

Buy-to-let mortgages under a central and a counterfactual scenario



Source: CML, Cebr analysis 2006-2017 data for the central scenario are actual data by the CML; 2018-2023 data are forecasts

Impact of BTL changes on the market outlook
continued

3.2 Rental yields

Rental yields are determined by two variables; the house price and the annual rental income from the property. Both of these indicators are affected by the government interventions in the BTL sector through various channels. Starting with house prices, we expect annual property price inflation to be more subdued in the five years to 2023 than over the last few years. The first signs of this slowdown were already visible in 2017. According to the ONS' House Price Index prices rose by just 4.7% in 2017, considerably slower than the 6%-8% recorded in the previous three years.

Our forecast for 2018 shows a similarly subdued picture for this year as the wider housing market struggles with a fall in transaction numbers, a pronounced slowdown in London and (to a lesser extent) the South East and waning foreign interest in London property investments. Stretched affordability ratios, years of weak wage growth and the prospect of further interest rate rises by the Bank of England further weigh on the outlook for house prices in the UK for the next few years. Our average annual house price forecasts for the years 2017 to 2023 therefore stands at 4.5%, compared to an average of 7.0% for the high-growth years of 2014 to 2016.

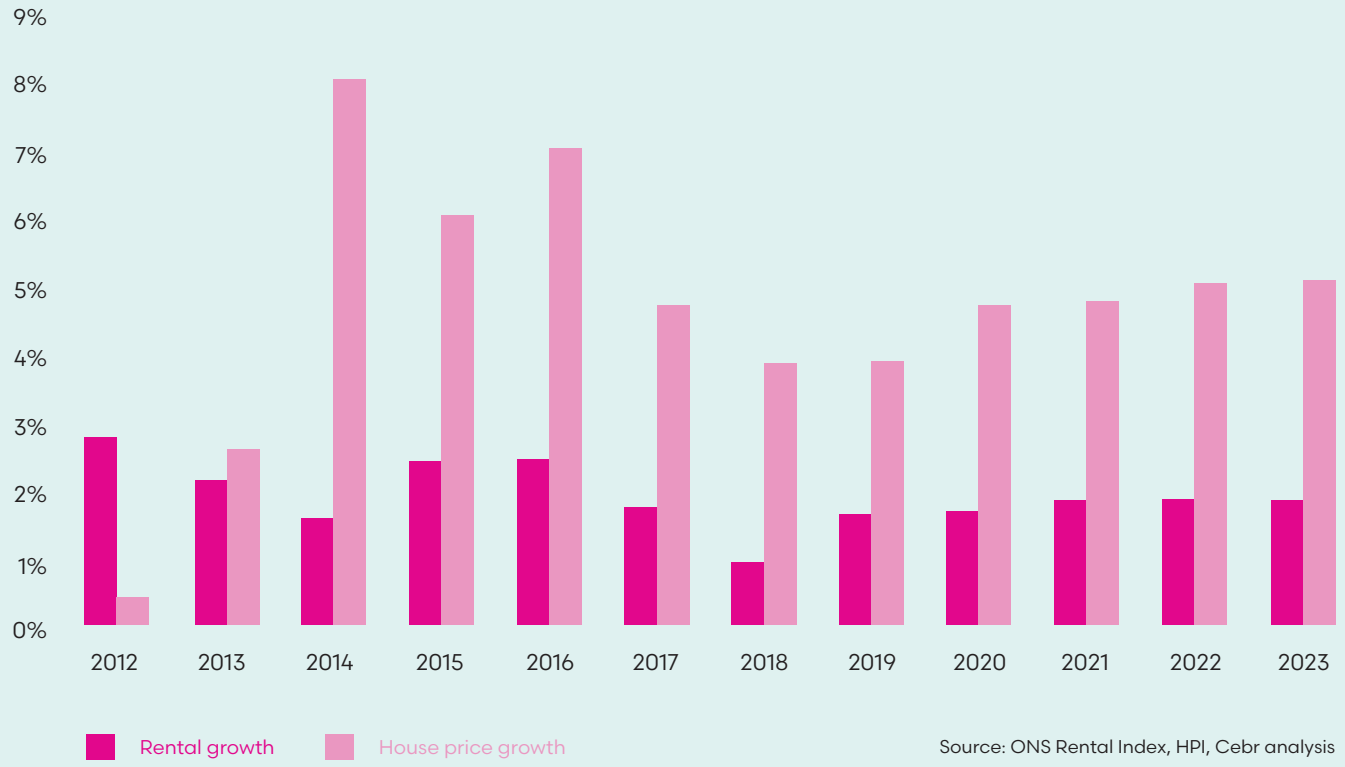
Having discussed our house price view under the central/actual scenario, we now focus on rent expectations. The picture here is somewhat more nuanced with large variations across regions. Notably, London, which has long been the bastion of high growth both for house prices and rentals, is now lagging behind the rest of the UK market. Rent expectations for the coming three months were the lowest in London out of all UK regions in February, according to the RICS residential lettings market survey. Average rent levels, especially in the capital, are also influenced by migration patterns given that recent migrants to the UK are more likely than the UK-born population to rent privately. While fears of a vast 'Brexodus' are somewhat exaggerated, net migration figures do suggest that the UK has become a less attractive place for foreigners in the aftermath of the Brexit vote. This softening in demand has lead us to expect growth of 0.9% in average rents across Great Britain in 2018 compared to 1.7% in 2017 and 2.4% in 2016, as shown in Figure 9.

The combination of limited potential for rental growth and the highest house prices in the country have made London less attractive for BTL investors as yields are pushed lower.

" We predict a downward trend in London, due to the challenges facing the professional investor and landlord community and their focus moving to building and maintaining a strong yield performance. This has led to a geographical shift in activity towards lower appreciating asset values that hold a higher yield, and a subsequent flight to regional areas that meet this criteria. Consequently there will be a natural slowdown in activity across the capital and we expect this to continue."

Shawbrook Bank

Figure 9
Rental growth and house price growth, Great Britain, forecasts to 2023



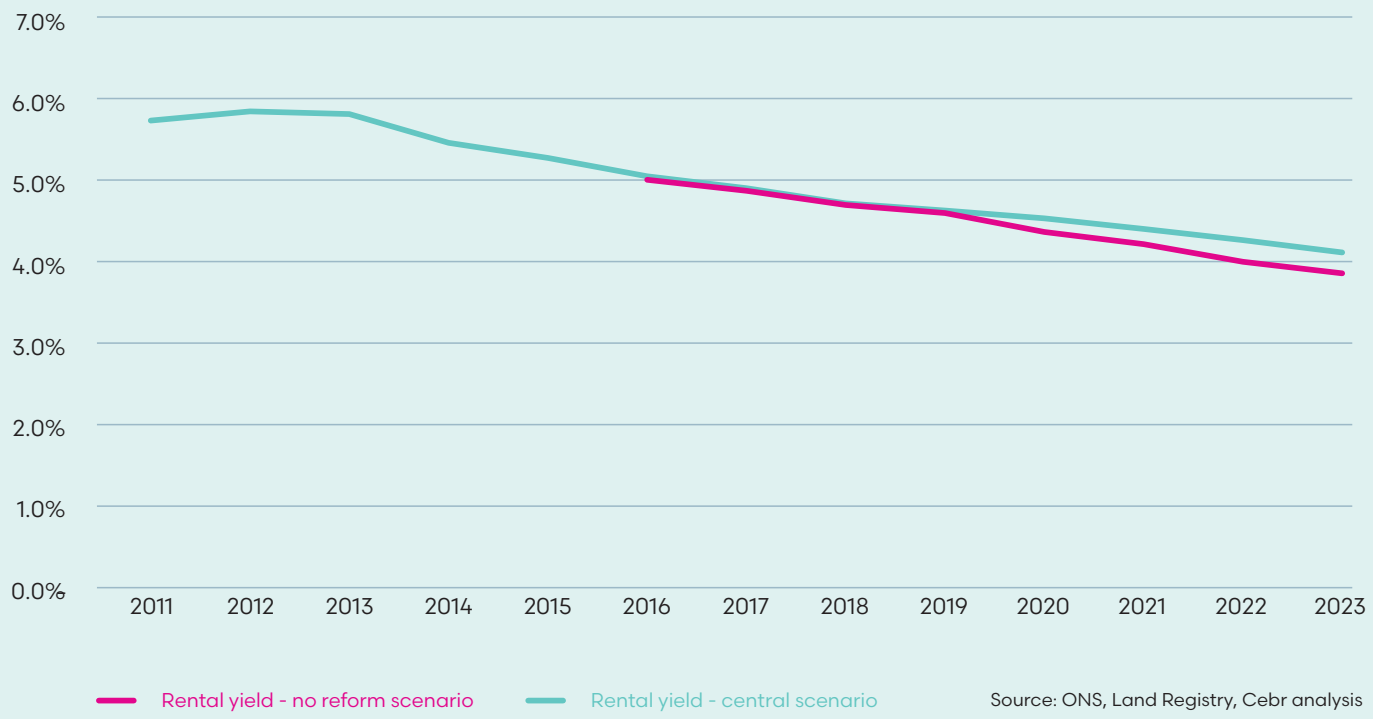
Source: ONS Rental Index, HPI, Cebr analysis

As a consequence of the BTL sector reforms our analysis shows that landlords have been pushed out of the markets or deterred from taking out new loans. This has consequences for the supply of rental properties in the country. Given an increasing demand for housing in the PRS the decrease in available properties should exert upwards pressure on rents.

As Figure 9 shows, our growth projections for average rents in Great Britain remain in positive territory throughout the forecast horizon under the central scenario. However, as we expect house prices to increase at a faster rate than rents, yields will come under further downward pressure. Under the central scenario we therefore forecast average yields to fall from 4.9% in 2017 to 4.1% in 2023.

Impact of BTL changes on the market outlook
continued

Figure 10
Rental yields – central and no reform scenario forecasts



Source: ONS, Land Registry, Cebr analysis

Figure 10 shows our yield expectations under the counterfactual, no reform scenario i.e. what we would have expected to happen if the government had not introduced tax changes and stricter underwriting criteria described in the previous section. While little would have changed between 2016 and 2019, we do forecast a more pronounced downward trend for rental yields in the 2020 to 2023 period. This is due to the fact that we would expect growth in rents to be more subdued under the counterfactual scenario as in the absence of government reforms, a greater supply of rental properties would have come onto the market. With a higher number of properties on the market we would expect to see stronger downward pressure on rents.

3.3 House prices

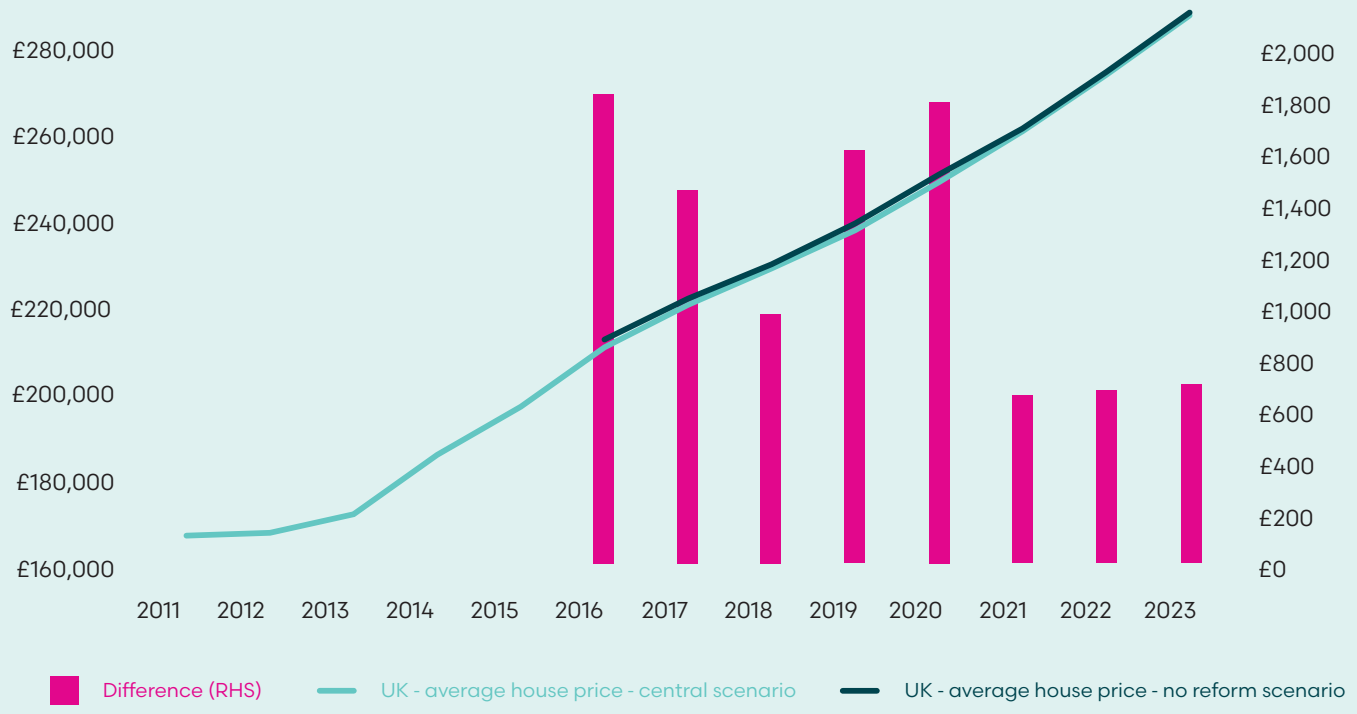
Finally, the government interventions in the BTL sector also likely had some effect on the wider housing market. However, the feedback loop from the BTL sector to the housing market as a whole is somewhat weaker when looking at headline indices such as housing transaction numbers. The share of BTL mortgages out of all new mortgages for house purchases steadily rose since 2010, reaching 14.7% in 2015. Since then, the share has fallen back to 9.2% in 2017, as the BTL sector lost some of its appeal in the wake of the tax changes.

By forecasting the number of BTL transactions under the alternative no reform scenario, we can also model the share of mortgages that would go to the BTL sector in this case. We further used the average deposit required for a BTL mortgage and the total pound-value for lending to calculate the average price of a BTL property. Using a weighted average between BTL and non-BTL properties we can therefore model the development of house prices under the central and counterfactual, no reform scenario.

Under the no reform scenario we would expect the share of BTL mortgages out of all mortgages to have stayed higher for longer, averaging around 13% between 2018 and 2023 compared to 7% under our central scenario. Without the tax changes, demand for BTL properties would at present arguably be higher, exerting pressure on prices. We would therefore expect that house prices would be higher had the government not introduced policies which have curbed demand in the BTL sector. However, the effect is estimated to be small, with house prices under the no reform scenario standing just 1% higher in 2016, the first year we assume that prices would have diverged. Over the forecast horizon this divergence varies somewhat before being reduced to 0.2% for the years from 2021 to 2023, suggesting that the BTL reforms have in the medium term only a very limited impact on UK house prices. This can mainly be explained by the fact that falling demand by BTL landlords will be partially offset by owner occupiers – as the former retreat from the market the latter step in to buy a home, limiting the fall in prices caused by the reforms.

Figure 11

House prices – central and no reform scenario forecasts, difference (right hand side)



Source: ONS, Land Registry, CML, Cebr analysis

4. Sector outlook

4.1 Impact on amateur and professional landlords

Mainly as a reaction to the reduction in the mortgage tax relief for private landlords, many BTL investors have considered transferring their properties into a private limited company as this enable landlords to treat mortgage interest payments as business expenses and therefore offset them against profits.

Furthermore, taxes on business profits currently stand at 19%, lower than income tax. According to the Shawbrook "Customer Barometer", (a yearly survey of Shawbrook Commercial Mortgage customers), 40% of borrowers plan to set up a company to counteract the increasing tax burden for individual landlords and one in 7 plan to use their spouse's personal allowance.[3] Industry data from Shawbrook bank confirm this trend. The share of commercial or semi-commercial originations had been falling steadily between 2013 and 2016. In the past two years, however, commercial loans have become increasingly common again. Between 2016 and 2017 the share of commercial originations rose from 12% to 20%. Clearly, this is a solution which is attractive for a number of individuals and indeed, industry data suggest that an increasing share of BTL lending goes to limited companies compared to private investors.

Nonetheless, it remains important to stress that turning properties over to a limited company is not always a suitable solution. There are two main factors private landlords need to be aware of. Firstly, borrowing through a limited company structure is generally more expensive than for an individual, offsetting some of the expected tax savings. Secondly, for private landlords with existing portfolios it can be very costly to actually transfer the properties into limited company ownership due to capital gains tax which is due upon the sale and stamp duty due when the newly set up company purchases the properties. Together these one-off payments can leave a significant dent in the finances of BTL investors, which makes careful planning necessary.

That being said, there seems to be an increasing drive for new mortgages to be issued to limited companies. Data by Shawbrook Bank show that the share of corporate customers has risen significantly over the past two years, rising from 50% in Q1 2016 to over 70% in Q4 2017.[4] As the mortgage tax relief is gradually phased out over the coming years BTL investments for private individuals will become less and less profitable, especially for higher rate tax payers. We therefore expect the trend to increasing professionalisation to continue. As a further consequence of the changes in the tax code, we also expect that with increasing professionalisation the average number of BTL properties per landlord will increase. Indeed, research from the Council of Mortgage Lenders[5] found that a quarter of landlords with only one rental unit backed by a BTL mortgage said they would sell their property in the next five years. This compares to only 4% of those with four or more properties who want to sell up. Of all BTL landlords planning to leave the sector more than half stated that changes to SDLT, mortgage tax relief, wear & tear allowance or other tax changes played a role in their decision.

A further change for professional landlords compared to amateur landlords is the differentiation in the underwriting process for those landlords with four or more properties – now called portfolio landlords. As outlined above, lenders need to have a specialised underwriting process in place for portfolio landlords following the PRA's BTL mortgage market review. This requirement specifically aims to clarify the distinction between smaller amateur landlords with few properties, and the more professional landlords who manage a larger number of BTL investments. The higher scrutiny that professional landlords with many properties can expect makes it harder to receive the required funding. However, in the long run, it seems reasonable that structural risks for highly leveraged borrowers are addressed early. Given both the uncertain economic outlook in the UK as well as the prospect of rising interest rates, one lesson of the financial crisis surely is that sensible planning and foresight are necessary to support financial stability and manage systemic risks.

[3] Shawbrook customer barometer
[4] Shawbrook Bank data
[5] Scanlon, Whitehead (2016), The profile of UK private landlords – CML Research

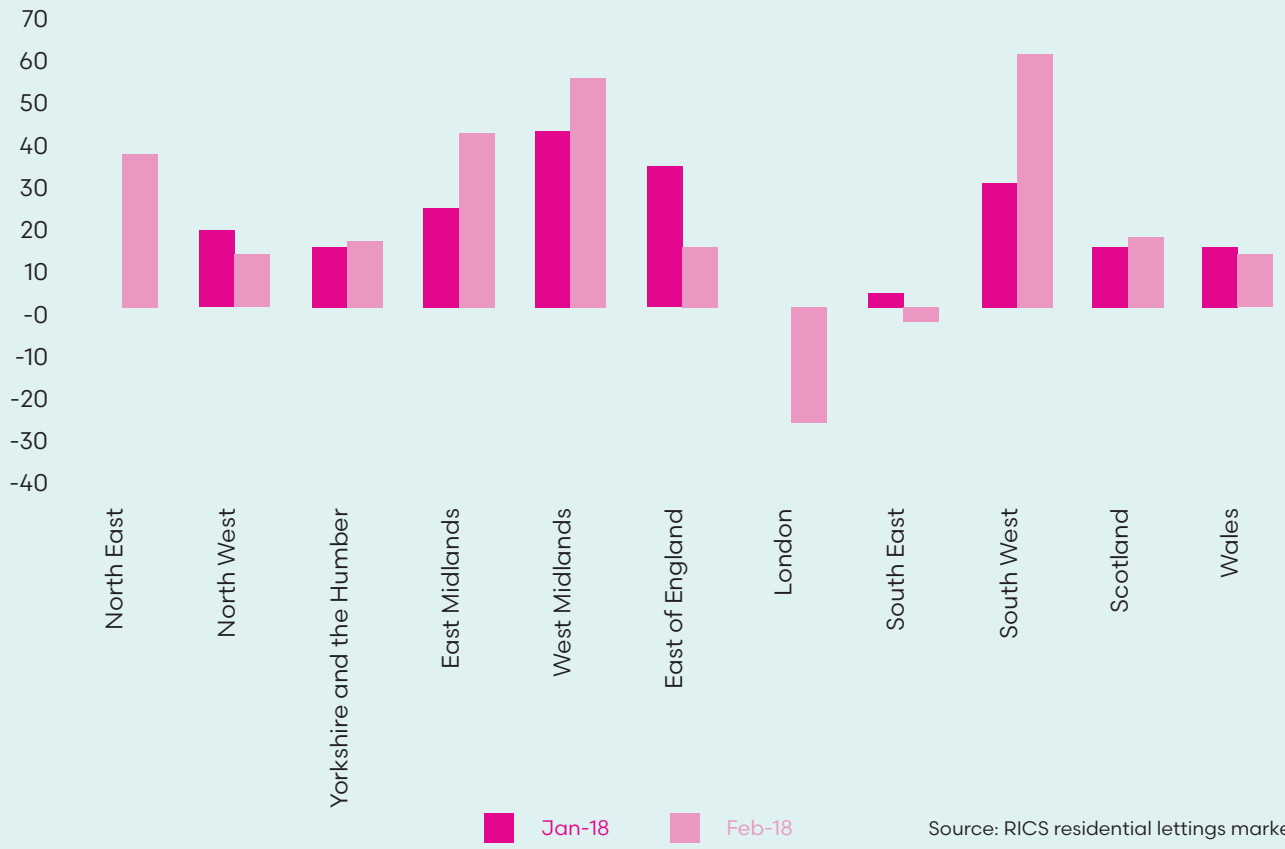
4.2 Chasing yield

A substantial amount of BTL lending is geographically concentrated with London alone accounting for nearly a quarter of BTL lending.[6] The South East and the East of England also command a large share of BTL loans with 15% and 10% though this is in line with the general regional distribution of residential mortgages. The high concentration in London specifically is a result of the rise of the PRS in the capital – demand for rented property has grown at fast rates over recent years enabling robust growth in rents. At the same time high house price growth further lured investors into the capital hoping for capital gains. However, things have changed in the last couple of years. The outlook for rental growth in London is the weakest in the country as seen in Figure 12, which shows the proportion of RICS letting agents reporting a rise in rent expectations minus the proportion reporting a fall.

In terms of house price growth, the capital is also experiencing a downturn after years of strong price rises. In Q1 2016, annual house price growth stood as high as 14% before decreasing sharply in the following months. Over 2017, price growth fell further to 2.1% year-on-year in the fourth quarter, the lowest growth rate of all UK regions. The reasons for this are varied, though one important factor is that affordability ratios in the capital are extremely stretched. Property in the capital has become too expensive for large portions of the population and subdued wage growth has limited tenants' ability to pay ever increasing amounts on rent. At the same time, international investors have taken a step back from the London property market due to changes in the way capital gains tax applies to holdings of residential UK property by foreign investors. Brexit and the resulting uncertainty regarding the future of the financial services sector in the City of London have further depressed activity in the prime end of the market as have higher SDLT rates. In summary, we expect price growth in London to continue to lag behind the rest of the country for the two years.

Figure 12

Rent expectations, net balance, 3 months ahead, by region

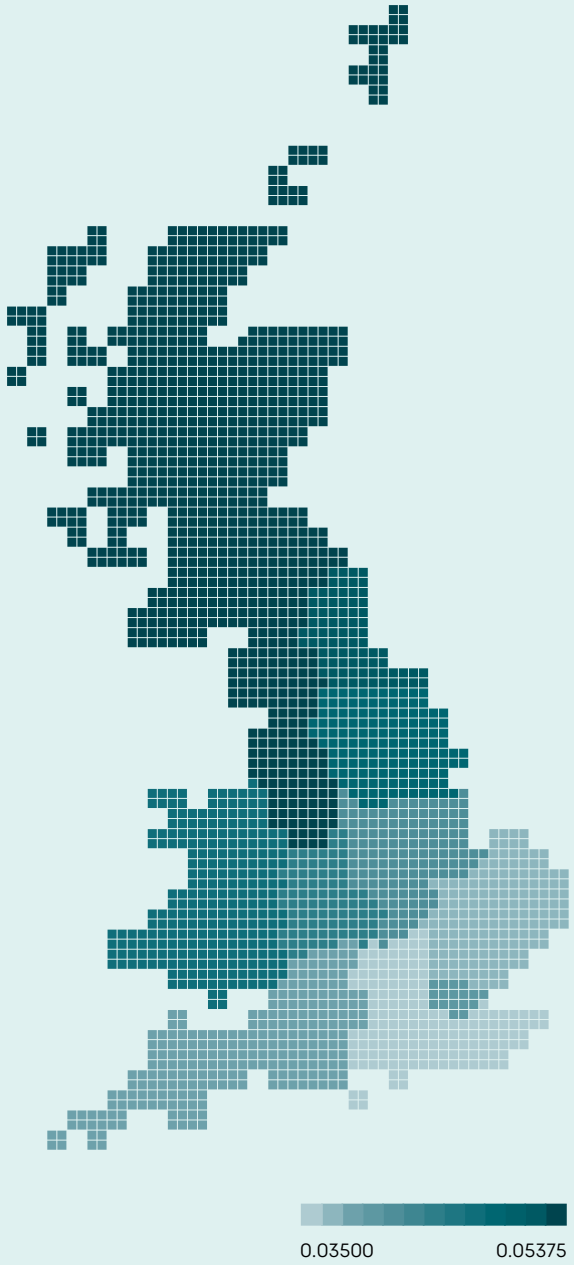


Source: RICS residential lettings market survey

[6] Retrieved from https://www.cml.org.uk/news/news-and-views/buy-to-let-the-past-is-no-guide-to-the-future/

Sector outlook continued

Figure 13
Heatmap of rental yields in Great Britain



Source: ONS, Cebr Analysis, Tableau

This improves the attractiveness of other regions for BTL investors. The North West region and Manchester in particular are frequently mentioned as new investments hotspots. Lower property prices mean that it is easier to achieve decent rental yields and the city is attracting students and employees from all around the country. This is confirmed by the data shown in the heat map in Figure 13. The darker a region is shaded, the higher the yield, based on current average ONS house prices and rental levels. The North West leads the ranking with an average yield of 5.4%, followed by Scotland with 5.3% and Yorkshire and the Humber with 4.9%.

Other areas attractive for BTL investors in the future are university cities that have seen more modest house price growth over the past years. Investors looking for the best yields can count on a stable demand for private rented accommodation from university students, while the purchase prices are still affordable. An analysis of rental yields by postcode area showed that cities like Liverpool, Middlesbrough and Plymouth offered better investment opportunities than the property hotspots of previous years such as London, Brighton or Birmingham.[7] However, investors should keep in mind that there are several challenges associated with managing property in another city. Knowledge of the local area is often an important factor for making an informed decision about in which properties to buy. And should problems with tenants arise, the geographical distance can complicate things.

Many investors are also looking at new asset classes in their search for higher yields, including houses in multiple occupation (HMO). In this case also, it is advisable that landlords familiarise themselves with the legal obligations attached with letting out HMOs and how these differ from regular privately rented property. Some of the unintended consequences of the professionalisation of the sector might include that landlords are pushed into regions and asset classes they are less familiar with, increasing the risk of bad investment decisions. To prevent this, it is essential that landlords seek professional advice ahead of making these moves.

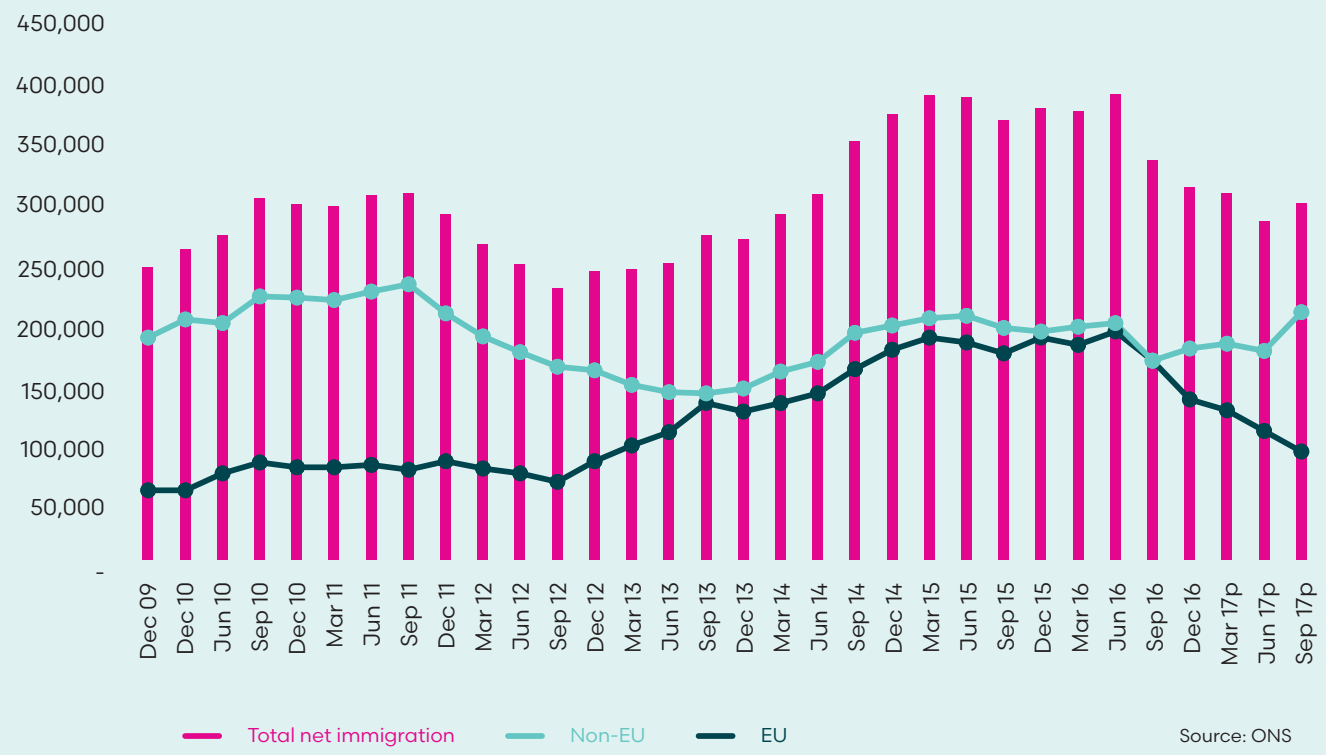
[7] Retrieved from http://www.totallymoney.com/buy-to-let-yield-map/

4.3 Brexit and the BTL market

Nearly two years after the UK voted to leave the European Union, many of the economic and political consequences remain unknown. Much still depends on the final deal between the UK and EU covering important topics such as trade in goods and services and the freedom of movement for capital and people.

One of the effects already observable since the EU referendum is a sharp drop in net migration from EU citizens to the UK, seen in Figure 14. While a decrease of EU migration was expected after Brexit, it is somewhat surprising to see net migration fall that quickly after the referendum, before any new regulations are in place. Immigration from non-EU countries has partially offset the decrease in the number of EU citizens coming to the UK, though total net migration has still fallen from 385,000 in the year ending Q2 2016 to 295,000 in the year to Q3 2017. As immigrants are more likely to live in private rented accommodation, we expect demand for rentals to decrease if this trends continues, especially in bigger cities which absorb most immigrants coming to the UK.

Figure 14
Net immigration to the UK by citizenship[8]



[8] Note: emigration by British citizens not considered in the graph

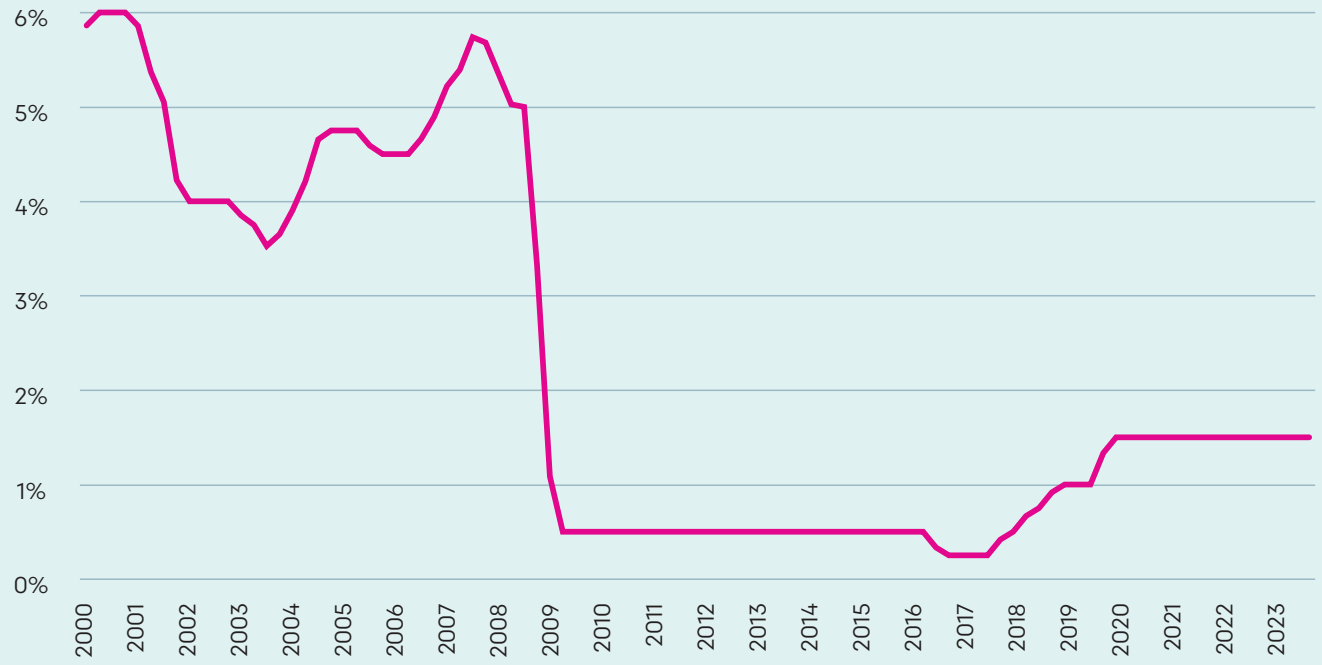
Sector outlook continued

A second major impact of Brexit on the UK's BTL sector will be the changes it brings to the financial services sector in London. The capital has for years been the unrivalled financial centre in Europe. Given this history, the networks and infrastructure in place, we don't expect this to change after Brexit. However, there is still a very real possibility that major banks re-locate some of their staff to the continent in order to be able to serve their clients on the continent. Given the current status of negotiations, a solution where London would keep its passporting rights – the ability to conduct business in any EU country – seems unlikely, forcing firms to open subsidiaries in another EU member states. If a substantial number of highly paid financial sector workers would leave London for another European city, this would likely be felt in the upper end of the London property market and changes in the top end of the market are in turn likely to affect lower price segments as well. This comes on top of a regional housing and rental market which is already in a weak position given stretched affordability ratios, an oversupply of luxury apartments and changes to the tax code that deter foreign investment. However, two years after the Brexit referendum a large-scale flight of bankers and financial sector workers to other European capitals has not happened yet. A number of factors speak for London when financial sector employees and their families make the decision for where to live. Many feel at home in London and value the capital's vast cultural and societal offer while for those with children, London's excellent schools are an important factor. London's infrastructure as a financial capital has grown over several decades and with it a stimulating environment for bankers and their partners. This will be hard to replicate in any other city, even more so for those cities where the language barrier is a significant drawback. Still, a likely outcome is a European re-balancing in which new graduates have a larger choice of cities where to start working. Top talent from France, Italy or Germany might no longer see London as the only viable choice to start their career in finance as large banks increase their presence in European markets. Therefore, even if a larger financial sector 'brexodus' is avoided, we might see a slower influx of new people coming into the city.

4.4 Future path of interest rates

Finally, an important determinant of future demand in the BTL market is the path of interest rates. BTL investments, and property more broadly, have become very attractive asset classes in the wake of the financial crisis not least because for those with the necessary money for a down payment, financing was relatively cheap. As we are approaching the end of the current cycle of monetary easing, central banks around the world are preparing to gradually increase interest rates. In the UK, the Bank of England raised rates for the first time in a decade in November 2017, though this hike could be largely understood as a reversal of the rate cut in the wake of the Brexit referendum. Markets currently expect up to two interest rises for 2018 and further increases in 2019 if the economic recovery continues. This means that borrowing costs are also expected to rise, which could in turn affect the attractiveness of the BTL sector and the wider housing market.

Figure 15
BoE base rate



Source: Bank of England, Cebr analysis

Figure 15 shows Cebr's expectation for the path of the BoE's base rate up to 2023. While still low by historical standards, interest rates of 1.5% are the highest for more than 10 years and many investors will have never experienced a cycle of rising interest rates. Fixed-rate mortgages are the preferred way for many to insure themselves against rising financing costs, though the risk here is that re-mortgaging at a later stage could lead to a cliff-edge scenario where borrowers suddenly face significantly higher interest rates than they had been paying.

Conclusion

The Buy-to-let sector continues to provide essential housing capacity in the private rental market. After seeing strong growth in the years from 2011 to 2015 recent government interventions and a slowdown in the housing market have had a notable effect on the sector. The number of BTL mortgages for house purchases has fallen sharply in the last two years, while record low interest rates continue to support the number of remortgages taken out as landlords shop around for the best possible deal.

This report looks at three main policy changes in detail: the introduction of a 3 percentage point stamp duty surcharge on second homes in April 2016, the gradual phasing out of the tax deductibility of mortgage interest payments starting in 2017 and the tightening of mortgage underwriting standards following a consultation by the Bank of England's Prudential Regulation Authority.

The presented evidence in this report strongly suggests that the substantial changes in the tax code as well as the tightening of underwriting standards have contributed to the decrease in BTL mortgages taken out. That being said, we estimate that a cooling of the market would have happened regardless as the BTL sector is closely linked to the wider housing market which is facing more tepid price growth and a regional decrease in transaction levels, especially in areas where affordability ratios are stretched such as in London.

Nevertheless, transaction levels have been noticeably lower since the introduction of the stamp duty surcharge. The change in mortgage interest tax relief will make BTL investments for a large number of private investors less profitable, an effect that still has to fully play out as the tax relief is withdrawn gradually over the next years. Further evidence from landlord survey commissioned by the Council of Mortgage Lenders shows that more than half of the landlords who stated they planned to sell-up their rental homes within the next five years mentioned the changes in stamp duty, mortgage tax relief and wear and tear allowance as a reason for doing so.

Our forecasts show that activity in the BTL market will further drop, though at a slower pace compared to the last two years. Given a generally weaker housing market and the numerous government interventions we predict that transaction levels will fall to around 57,500 by 2023. While the effect on overall house prices should be rather small, we expect yields to be higher compared to a scenario where the tax changes were not implemented, given that the lack of housing supply generated by BTL landlords should drive up rents.

The good news is that the professionalisation of the sector and more sustainable lending practices are likely to have positive effects in the long run. Given that the PRS will play an increasingly important role in the UK's tenancy mix, there is still a market for BTL landlords with a sustainable business plan and a good understanding of the legal and tax implications. Looking ahead, we expect the professionalisation of the sector to continue.

BTL investors should carefully consider the latest changes in taxation when evaluating their next steps. Additionally, the regional focus of the sector is shifting. With its larger demand for PRS housing, London has long dominated the BTL sector. But a flat housing market and limited capacity for rental growth in the capital means that other places in the country offer better yields to investors, especially cities with large student populations. Brexit adds a further layer of uncertainty – with a number of City jobs at stake, London's housing market might be in for a further price correction. Also, immigration patterns – while notoriously hard to predict – should be closely watched. A clear drop in EU immigration is already discernible in the data, translating into lower demand in the PRS.

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