SHAWBROOK BANK

THE UK BUY-TO-LET MARKET

JUNE 2017

COMMERCIAL MORTGAGES

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Compiled by the Centre for Economics and Business Research

Authorship and acknowledgements

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The report does not necessarily reflect the views of Shawbrook Bank.

London, April 2017

FOREWORD FROM STEPHEN JOHNSON

Thank you for taking the time to read this research piece, commissioned by Shawbrook Bank and conducted by the Centre for Economics & Business Research (Cebr).

When we set out to define the scope of this research, our aim was not only to provide a snapshot of the Private Rented Sector (PRS) and how this key component of UK housing and the economy was likely to trend moving forward, but also to analyse specific issues in more depth such as the changing tax regime and the impact of the affordability changes recently introduced by the Prudential Regulation Authority (PRA).

We knew that these issues were at the forefront of professional landlords and investors' minds, but the question remained as to how big an impact would they have on the prospects of the PRS relative to the equally well-publicised challenges of increasing house prices and owner occupied affordability. Will they materially change the investment case for landlords and thereby remove an important supply of housing provision? Is it too simplistic to assume lost landlord supply will be replaced by increased home ownership?

This independent piece of research shines a light on the sector, contextualising many of the more recent regulatory interventions against historic data from across the Buy-to-let market.

We hope that you find this research valuable, and that it helps to encourage a balanced dialogue on the many challenges faced by landlords, financial intermediaries and lenders. We also hope it contributes to the on-going commentary on the buy-to-let sector, a market that remains a preferred investment choice for many individuals and provides nearly 21% of UK housing.

Yours sincerely,

Stephen Johnson
Deputy CEO & Managing Director
Shawbrook Property Finance

EXECUTIVE SUMMARY

This report for Shawbrook Bank provides new insights into an integral part of the UK housing market – the Buy-to-let (BTL) sector.

Since the mid-1990s the number of private landlords buying a property to let in the rental market has risen greatly. While the financial crisis of 2007-2009 impacted the BTL market, the recovery since has been remarkable. With one in five mortgages going towards the BTL market, the sector has drawn the attention of the government and regulatory authorities, who are concerned with maintaining the chances of first-time buyers in the market and limiting risks to financial stability.

The report finds that:

- The rise of Buy-to-let is closely linked to the renaissance of the private rental sector in the UK. The share of households living in rented accommodation has risen from 11% in 2004 to 19% in 2014 and is expected to increase further in the coming years.

- Buy-to-let lending is heavily concentrated in London. The capital accounts for almost one in four BTL loans (24%), compared to 13% of loans for owner occupiers. The high number of students, young people and international workers are all driving demand for rental properties. High property prices make buying a home unaffordable for a large number of people, creating additional demand in the private rented sector.

- Changes in the mortgage tax relief reduce profitability of BTL for a number of investors. BTL investors who need to pay back a mortgage on their property need to be aware of the recent changes in the tax code. As the tax relief on mortgage interest payments is reduced, some investments may no longer be profitable for private landlords. To give an idea about the number of affected borrowers, specialist lender Shawbrook Bank's figures suggest a significant proportion of BTL mortgages are held by private landlords in terms of the existing mortgage book. The lender is seeing a shift in behaviour at the front end with LTD company purchase applications increasing.

- We expect commercial landlords to gain market share in the BTL sector. Since the tax change for mortgage interest payments only affects private landlords, commercial landlords and those who register their business as a private limited company enjoy a cost advantage that is expected to increase their market share.

- Last year's stamp duty surcharge increases the upfront cost for BTL landlords and has wider unintended consequences for tenants. The measure has been successful at deterring buyers from the market with BTL transaction numbers 30% below the levels seen before its introduction. Looking at the medium term it is likely that higher costs will be passed on to tenants.

- The tightening of underwriting standards by the Prudential Regulation Authority (PRA) will decrease the supply of credit available to landlords. Borrowers now have to disclose more comprehensive financial plans and demonstrate the profitability of the investment under a 2% interest rate stress-test. Portfolio landlords also will have to pass more complex tests of their business models.

- Leaving the European Union will have knock-on effects for the BTL market. It is highly probable that such a transforming event as leaving the EU will have reverberations in the wider housing market as well as in the BTL market. Reduced immigration could limit demand for rental properties in some areas. However, builders already cite skills shortages as one of the most important constraints to increasing housing output. Without skilled workers from the EU, builders will have a hard time finding sufficient workers to achieve the housing output targets set by the government, further constraining supply.

1. INTRODUCTION

This report for Shawbrook Bank examines the Buy-to-let (BTL) sector and its role within the greater context of the UK housing market.

The private rental sector has become increasingly important in the tenancy mix of the UK, experiencing a renaissance after decades of stagnation. With elevated house prices and equally fast-rising deposit levels, buying a home has become increasingly difficult for many households who rent. Another factor leading to the rise of the private rental sector is a change in the preferences of younger generations, especially in urban areas, who prefer to remain flexible and not to be tied down with huge amounts of housing debt. Students and working migrants are other groups that add to the demand for rented accommodation. No matter what the motivations are, the increase in the share of households renting is set to continue in the future. This, in turn, has important implications for the BTL sector as one of the most important suppliers of rented accommodations.

The first section of this report examines activity in the BTL sector over the past decade and takes a more detailed look at the regional differences in the market as well as the property types bought with BTL loans.

The report then moves on to analyse the various recent changes in the regulatory and legal environment for BTL landlords. Here, the government's changes to tax relief on mortgage payments and the stamp duty increase on second homes present new challenges for BTL landlords and is having a substantial impact on the market. Furthermore, the results of the Bank of England's new underwriting standards for BTL mortgages will be examined. The report concludes with an overview of what Brexit could mean for the BTL market.

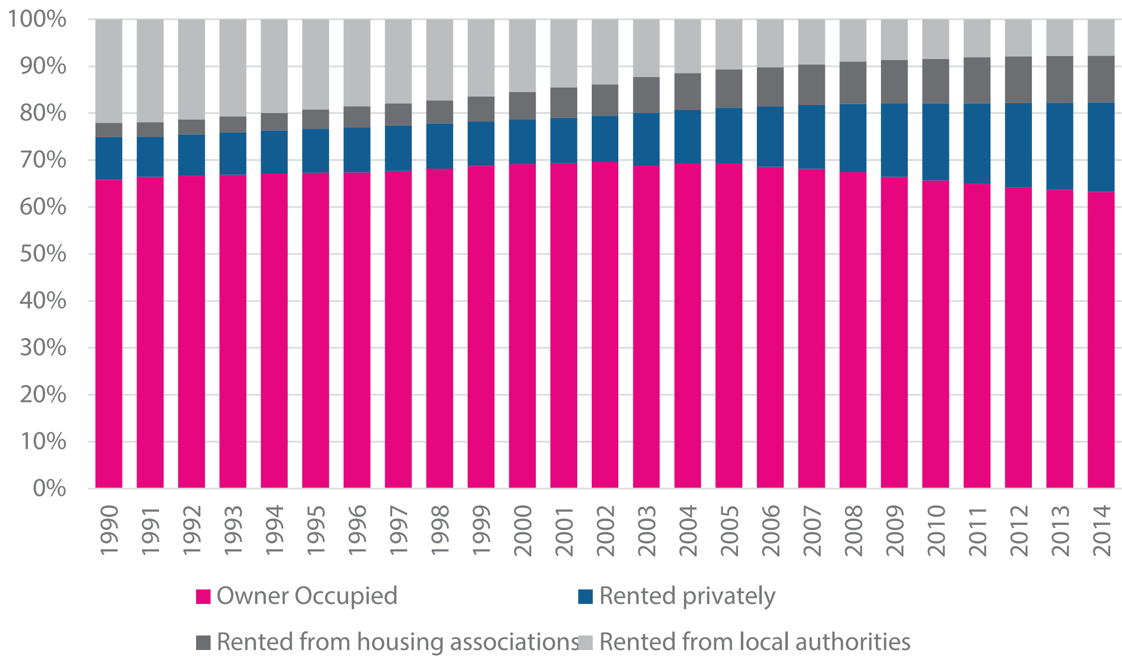
2. ANALYSING THE BUY-TO-LET MARKET

The number of households renting privately has been steadily on the rise for the past 15 years, putting the Buy-to-let (BTL) market in the spotlight.

Data from the English Housing Survey show that the share of households in the private rented sector has increased from 9% in 2000 to 18% in 2014. Figure 1 shows that the increase in the number of households in the private rented sector has coincided with a declining share of households renting accommodation from local authorities. The recent decline in the number of owner occupiers has also led to more people renting their homes in the private sector.

There are a number of reasons for these developments. Among the most important drivers are the fast rising house prices in the UK. Since the trough during the financial crisis in 2009, house prices in the UK have risen by 32%, far outstripping the pace of wage growth – nominal earnings have only risen by about 14% in the same time. This trend is more apparent in major cities. House prices in London have risen by more than 80% in the previous seven years. The reason for this is a vast discrepancy between housing supply and demand. For years, the pace of building new homes in the UK has not kept up with increasing demand. Even today, not enough homes are being built where they are needed putting pressure on house prices in those regions. Worsening affordability, the ratio between income and house prices, has led to a situation where a large number of families cannot afford to buy their own home even if they wanted to.

Figure 1: Tenure trends in the UK



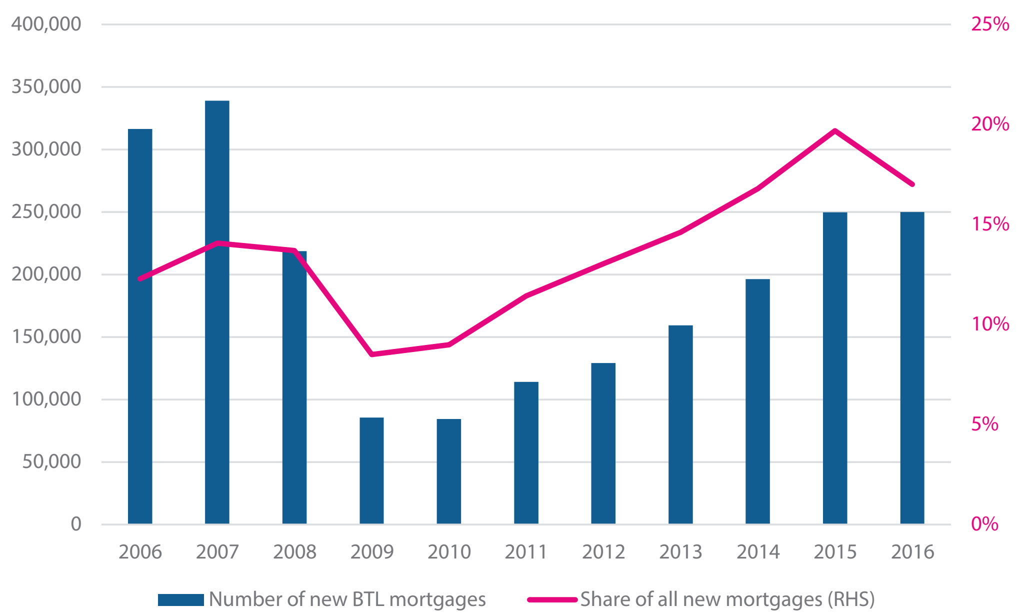
Source: ONS

Rising deposits and unaffordable monthly mortgage payments (despite record low interest rates) are among the main reasons why households remain in the private rented sector for longer than planned. Of course, there are also people who prefer the flexibility of renting their home over the burden of taking on substantial mortgage debt and tying oneself to the movements of the property market. This applies to the increasing number of students and young professionals, who plan to move on in a few years' time. For newly arrived migrants, rented accommodation is often the preferred option both for flexibility and in terms of cost. According to the latest housing whitepaper, even the government has come to the conclusion that the future of the UK housing market will be more diverse, moving away from the vision that everyone should be a homeowner.

This is where the BTL sector comes into play. Buy-to-let mortgages were launched in 1996 to facilitate the purchase of residential property with the intention of letting the property to a tenant in the private sector. This includes lending for the purpose of buying houses in multiple occupation (HMOs), which are defined as properties rented out by at least three people who are not from the same household but share facilities such as bathroom and kitchen. A shared house or flat, for example, fall under this definition. The interaction between the BTL market and the rest of the property market is complex: BTL landlords provide much-needed properties in the private rental market. On the other hand, they arguably reduce the stock of available dwellings for first-time buyers and others, who plan to live in their own home, thereby creating further demand for rental properties.

Figure 2 shows how the number of BTL mortgages has evolved over the last 10 years. In total numbers, new BTL mortgages (for house purchases and remortgaging) peaked in 2007 before the financial crisis hit and the housing market faltered. The fact that the blue line dips sharply in 2009 indicates that the share of BTL mortgages among all new mortgages decreased from around 12% to 8%. This suggests that the BTL market reacted even more to the crisis than the owner-occupier market. In the years of the recovery, the BTL market gained substantial momentum, recovering quicker than the broader housing market. In total numbers, new BTL mortgages increased by almost 200% between 2010 and 2016, while their share among all mortgages also increased to 20% in 2015, before falling back slightly in 2016.

Figure 2: Number of new Buy-to-let mortgages BTL mortgages as share of all new mortgages



Source: CML, Bank of England, Cebr analysis

The popularity of BTL mortgages can partly be explained with the recovery in the housing market following the crisis. Record low interest rates – set by the Bank of England to stimulate the UK economy in the wake of the crisis – were another important factor. They decreased the cost of mortgages while at the same time lowering the return on classical savings products, driving a large number of private investors into the BTL market, which promised far higher returns.

Consequently, the rapid increase in BTL landlords has raised concerns with the regulatory authorities. Both the volume of investment in the BTL sector and the potential exposure to changes in interest rates were cause for worry about the potential impact on financial stability. In 2016, the Bank of England published the results of a consultation into underwriting standards for BTL mortgages; shortly thereafter, HM Treasury granted the Bank's Financial Policy Committee powers of direction in the BTL market, enabling it to tighten or loosen lending standards if deemed necessary.

2.1 The regional distribution of BTL activity

Figure 3 shows the regional distribution of BTL loans compared to residential loans. In almost all regions, loans to owner occupiers and BTL mortgages are nearly equally distributed with one glaring exception: London alone accounts for almost a quarter of all BTL loans compared to only 13% of residential mortgages. Given that the demand for BTL mortgages is closely linked to the demand for rental units and HMOs, this is not very surprising. According to data from the Council of Mortgage Lenders (CML), 27% of all dwellings in the capital are rental units, the highest concentration in the country. For the remaining regions, the share of BTL loans is closely linked to the respective size of the mortgage market. Only Yorkshire and the Humber and Scotland stand out with slightly lower shares of BTL mortgages compared to residential mortgages.

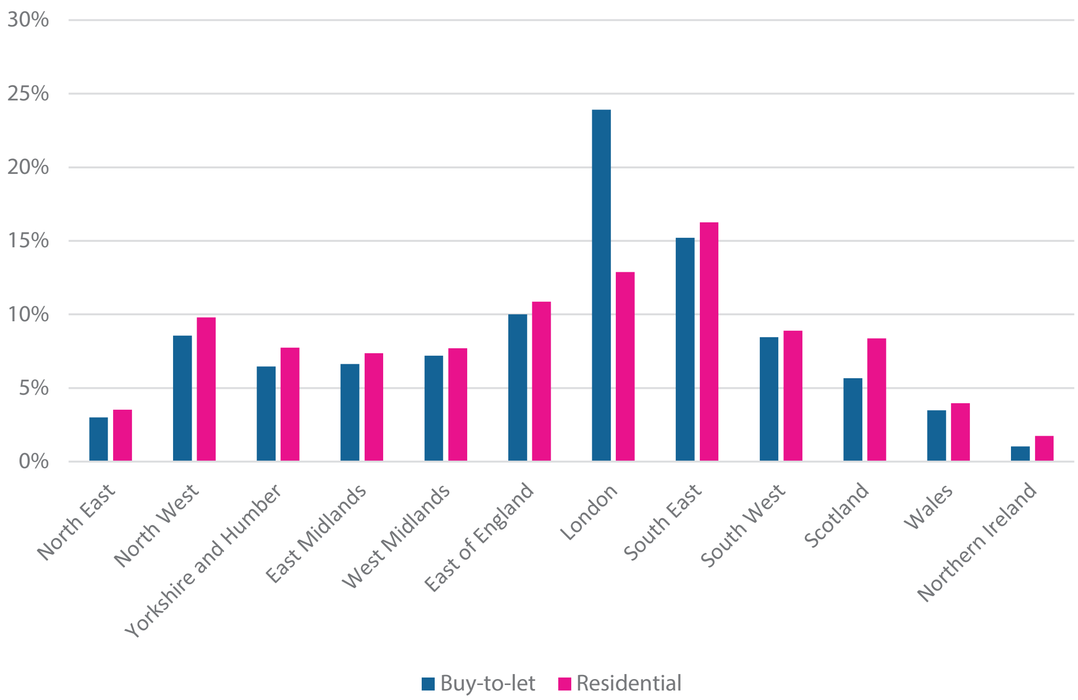
The high share of BTL activity in London can be explained by the interplay between most of the drivers of private rental demand outlined above. A large number of migrants coming to work in the city are one reason for the boom of BTL. Rented accommodation is preferred by a large share of the international workforce in the capital, who are not necessarily planning on settling down in the UK permanently. Along the same lines, London is also the temporary home for a large number of students, both from the UK and from overseas. Furthermore, the high unaffordability of houses in London is forcing many households into the private rental sector, who struggle to save up enough money for a mortgage deposit. As a result, London has seen consistent growth in the number of households renting privately, many of which are HMOs.

Data from the CML also allows us to take a look at the types of property bought by owner occupiers and BTL borrowers. Figure 4 shows that loans for owner occupiers are typically used to buy houses, either detached, semi-detached or terraced. The most common use for a BTL mortgage is to purchase a flat with 36%, closely followed by terraced houses (34%). The distribution follows the demand for rental properties – and renters are far more likely to live in flats or a terraced house than in a detached or semi-detached house.

2.2 Buy-to-let as an asset class

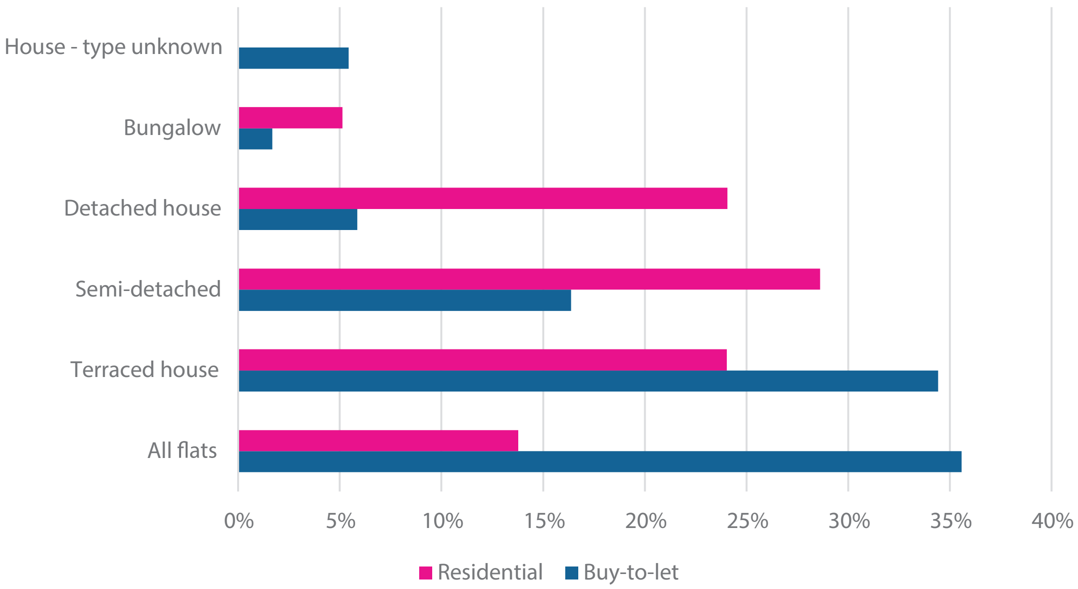
The attractiveness of BTL as an investment class can be measured in various ways. Two of the most important indicators for the evaluation of every BTL investment are rental yields and capital gains. Rental yields are calculated as annual rent as a share of the property value, assuming that the property is bought outright. Areas where rents are high relative to house prices will therefore have higher rental yields. Potential BTL landlords should also take into account the change in value of the property. The price appreciation in properties, i.e. the capital gains, are an important factor in calculating the profitability of a BTL investment. Potential buyers should, however, always keep in mind that house prices can go down as well as up. The high BTL activity in the London market can also be explained by the higher expected capital gains due to rising property values. For many landlords this will more than compensate for the relatively modest rental yields in London.

Figure 3: Geographical spread of Buy-to-let and owner occupier loans



Source: CML

Figure 4: Types of property bought by owner occupier and Buy-to-let borrowers



Source: CML

3. CURRENT DEVELOPMENTS IN THE BUY-TO-LET MARKET

In the previous section we discussed gross rental yields, defined as gross rental income divided by the purchase price of the home. In reality, many BTL investors will need to take out a mortgage in order to buy a property. In order to get a more accurate picture of the return on investment that can be expected, it is therefore necessary to take the mortgage costs into account.

Due to recent changes in the way in which mortgage payments can be deducted from landlords' tax bills, this has become even more important.

3.1 Changes in mortgage tax relief

Starting from April 2017, Buy-to-let landlords will no longer be able to deduct the full cost of their mortgage interest payments from their tax bill. The amount that can be deducted will be reduced gradually 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.

As limited companies will not be affected by this change, some landlords are setting up companies to mitigate the new tax regime. However, HMRC treats the transfer of ownership of a property as a sale subject to capital gains tax, which means that investors should carefully consider such a step. Capital gains tax accrues if the property has risen in value since the original purchase and stands at 18% for a basic rate tax payer and 28% for a higher rate tax payer. Furthermore, selling a property into a limited company triggers stamp duty, including the 3 percentage point surcharge on second homes and BTL property, introduced in April 2016. As the ownership of the property changes, mortgage contracts also need to be renewed, which means that valuation and legal fees will be due. Additionally, complying with the regulatory and reporting requirements for limited companies is time consuming and comes at an additional cost. So while commercial landlords, who have registered their business as a private company, are exempt from the higher tax rates on mortgage interest payments, they face substantial upfront costs when selling the property into the company. Whether setting up a private company is the right choice for private BTL landlords needs to be decided on an individual basis and should not be done without careful consideration and planning.

The new tax relief regime is going to make the BTL sector less profitable for a wide range of private landlords. Most will see their tax bill increase drastically and investors with high mortgage interest payments compared to the rental income the property generates will see their profits completely eroded by mortgage costs and taxes. With the introduction of these measures, the government aims to reduce the number of private BTL landlords in the market in favour of larger, institutional investors. While a professionalisation of the investors and the market in general could have positive effects for tenants, who could benefit from better services and more responsible landlords, it remains quite a drastic intervention in the market. Demand for private rental accommodation is projected to remain strong due to a variety of factors, including low affordability pushing homeownership further out of reach for many and changing preferences of a more mobile population. For example, the Halifax Generation Rent Report found that the share of 20-45 year-olds, who don't want to own their home has increased from 13% to 16% between 2011 and 2015. As a reaction, landlords have the incentive to try and pass the increase in cost on to the tenants. Since many households do not have a viable alternative to renting privately, their demand is price-inelastic, meaning they cannot react to an increase in prices by switching to a cheaper form of accommodation. Another potential outcome is that private BTL landlords are largely pushed out of the market, leaving the supply of rental homes in the hands of a few large organisations. This would decrease competition in the market and could ultimately lead to worse conditions for tenants.

Undoubtedly, the changes will affect a large proportion of the current BTL market.

To give an idea of the size of the BTL market for individual landlords, we can take a look at the make-up of the loan book of Shawbrook bank, a specialist lender founded in 2011. This particular bank extended almost 60% of their BTL loans to private landlords, representing around 54% of the total value of BTL loans in their books. Extrapolating from one single bank to the entire BTL market is difficult but the example gives a rough idea about the impact the change in mortgage tax relief rules will have, and shows that a substantial number of borrowers are private landlords. If we expect that the number of BTL loans in the coming years lies between 200,000 and 250,000 per year, the number of affected borrowers would stand at 120,000 to 150,000.

CHANGE IN MORTGAGE TAX RELIEF – WORKED EXAMPLE

Private BTL Landlord

To better illustrate the effects of the change in the tax relief of mortgage interest payments, we can imagine a BTL investor collecting a rental income of £5,000 per month and mortgage interest payments of £4,000 per month. This leaves the investor with a profit of £1,000. According to the old tax regime, the landlord would pay tax on the profit from his BTL investment, i.e. after deducting the mortgage interest payment. If we assume that the landlord pays 40% income tax, the bill would amount to £400, leaving £600 of after-tax profit.

After the changes in the tax code will be fully phased in, BTL landlords can no longer claim the cost of their mortgage interest payments, apart from a 20% rebate. In our example, the landlord would need to pay 40% tax on the entire rental income of £5,000, i.e. £2000, less £800 (20% of the £4,000 mortgage interest paid). The final tax bill stands at £1,200 - three times the amount paid before the changes and higher than the initial profits from the BTL.

Limited company

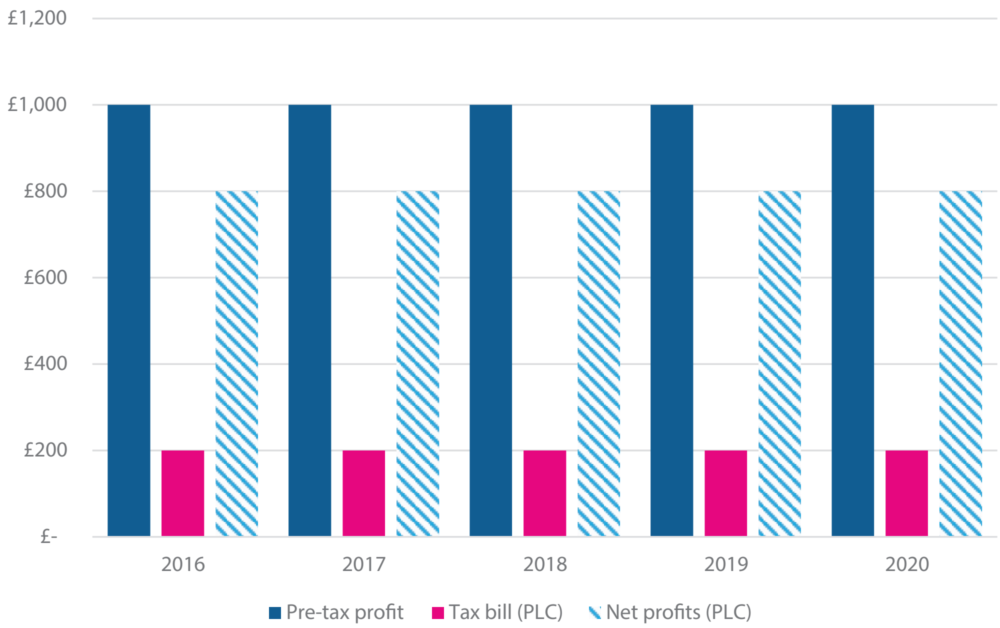
For limited companies, the changes to the mortgage interest tax relief do not apply. If we assume, for simplicity, that a company had the same rental income of £5,000 per month and the same mortgage interest payments of £4,000 per month, this would leave £1,000 as pre-tax profit. As the tax changes do not affect companies, they will still pay tax only on their profit rather than the rental income. Sticking with the example and in the absence of any other profits or expenses claimed, this means the company would need to pay 20% tax on the £1,000 profit, or £200, leaving £800 as after-tax profit. Additionally, the treasury has indicated that the corporation tax could fall even further in the next years, increasing the profitability of companies.

For a graphical representation of the two worked examples, please refer to Figure 5 and Figure 6 of this report.

An additional change in the tax code concerns the so-called wear and tear allowance. Up to the financial year 2015/2016, BTL landlords were able to claim a 10% wear and tear allowance for fully furnished rental properties to compensate for any repairs or replacement of furnishings. As this rebate could be deducted as a flat rate, even if no furniture was replaced or repaired, this was generally a financial benefit for landlords. Starting with the financial year 2016/17 landlords can only claim a tax relief on the costs actually incurred on replacing furnishings, appliances and kitchenware in the property.

Figure 5: Pre-tax profits, taxes and net profits under the new mortgage interest tax regime, private landlords

Figure 6: Pre-tax profits, taxes and net profits under the new mortgage interest tax regime, limited companies



3.2 Change in Stamp Duty on second homes

Another change in the tax code affecting BTL investors came into effect in April 2016. The government increased the stamp duty buyers need to pay on second homes including BTL properties by 3 percentage points. This change increased the upfront cost for a BTL investment significantly (see Table 1). Similar to the measures reducing the mortgage payment tax relief for BTL landlords, the increase in stamp duty on second homes is part of the government's strategy to promote homeownership and support first time buyers. The government assumes that if fewer people buy a second or third home, more can buy their first home on the market.

The introduction of the additional levy had a clear impact on the market. Many buyers who planned to buy a second home or BTL property in the first half of 2016 rushed to finish all transactions before April.

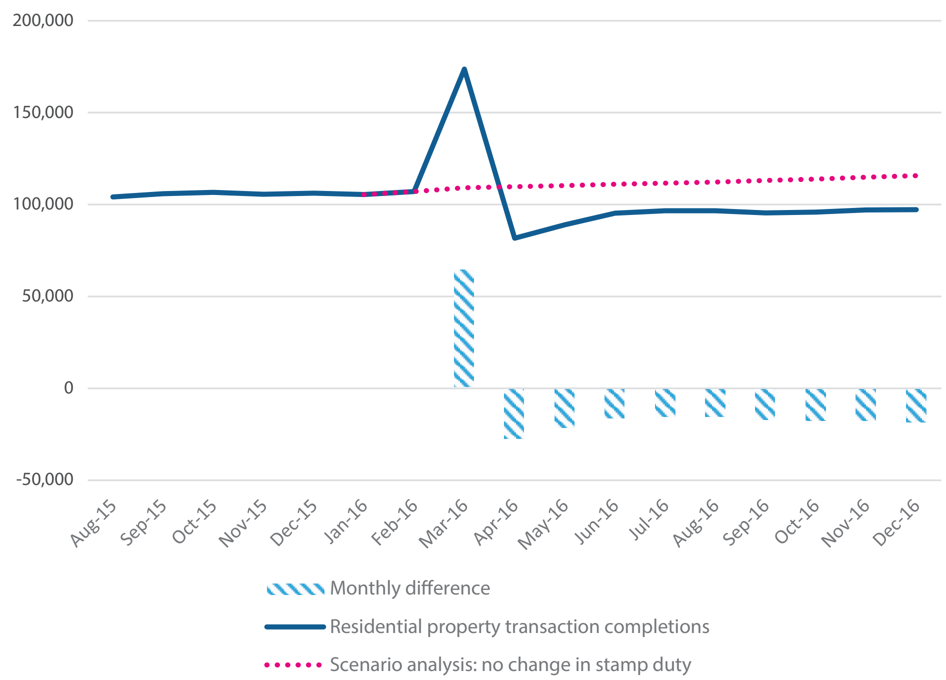
Table 1: Property values and applicable Stamp Duty Land Tax rates, from April 2016

Property Value	Existing residentialSDLTrates	New additional propertySDLTrates
£0* - £125k	0%	3%
£125k - £250k	2%	5%
£250k - £925k	5%	8%
£925k - £1.5m	10%	13%
£1.5m +	12%	15%

*Transactions under £40,000 do not require a tax return to be filed with HMRC and are not subject to the higher rates.

Source: HMRC

Figure 7: Residential Property Transactions Completions, seasonally adjusted



Source: HMRC

The result can be seen in the transaction numbers for the respective months. After fairly stable transaction numbers of around 100,000 per month from 2015 until February 2016, the number skyrocketed to over 170,000 in March, before falling by more than 50% to around 80,000 in April when the tax went into effect, shown by the blue line in Figure 7.

The introduction of the surcharge has had a lasting effect on transaction numbers, which since haven't recovered to levels seen in the months before April. The cumulative number of completed residential property transactions in 2016 stands at 1,231,120. If we extrapolate the trend of the months before April – shown by the pink dotted line – this number would have been approximately 100,000 higher had it not been for the surcharge.

The monthly gap between actual transaction numbers and those from our scenario analysis are represented by the blue and white bars in Figure 7. Remarkably, these gaps have remained fairly stable over the second half of the year. In other words, transaction levels are only returning very slowly to the levels seen before the introduction of the stamp duty surcharge, suggesting that the additional levy permanently deters those buyers affected from the market.

While the motivation of the government behind the changes in stamp duty is understandable, it is possible that this change has led to some unintended consequences. Similar to the changes in mortgage tax relief, it cannot be ruled out that potential BTL landlords simply pass on the higher upfront cost to their tenants in the form of higher rents. With long waiting lists for social housing provided by housing associations or local authorities and unaffordable house prices, a large number of households in the UK are dependent on the private rental market and are subject to the potential rent increases. For first-time buyers on the other hand, improvement has been marginal, as house prices in the UK rose undeterred by around 7.6% in 2016.

3.3 Underwriting standards for BTL mortgages

Not only the government, but also regulatory authorities have recently intervened in the BTL market. As mentioned earlier, the Bank of England is concerned with the financial stability of the UK. As the BTL market has substantially increased in volume over the past few years, the Bank's Prudential Regulation Authority has announced that it seeks to make sure that the BTL sector is well-equipped for potential shocks in the financial system. The profitability of most BTL investment depends to a large extent on the interest paid on the mortgage on the BTL property. Although interest rates have been historically low in recent years, this will not necessarily continue to be the case in the future. The danger here is that a large number of BTL investors are not able to afford their mortgage payments if interest rates rise. The potential impact of this is augmented by the changes to the mortgage interest tax relief mentioned above and the expected growth in the market over the coming years.

In an effort to enhance underwriting standards the PRA has announced that from January 1st 2017 onwards, BTL mortgage lenders have to abide by stricter rules to authorise loans. Lenders now have to conduct a stress test on interest rate rises as well as further affordability checks before approving a BTL loan.

Lenders will be required to conduct stricter affordability tests on potential borrowers, who need to demonstrate that the rental income generated from the BTL property (or other types of income) is sufficient to cover interest and capital repayment for the mortgage as well as all associated tax liabilities, insurance payments and management costs. Potential borrowers must show the ability to repay their mortgage at a 5.5% interest rate for at least the first five years. To that end lenders must calculate an interest coverage ratio (ICR) for borrowers, defined as the ratio of the expected monthly rental income from the BTL property to the monthly interest payments. Additional interest rate rises might be included in the stress test.

Portfolio landlords – personal or corporate borrowers who have at least four mortgaged BTL properties – will have to be assessed using a specialist underwriting process. The PRA reasons that portfolio landlords have more complex structures in place and pose a greater risk due to their larger aggregate levels of debt. If landlords hold a large number of properties in a confined geographical area, this further exposes them to any fluctuations in rental demand and house prices in that area. Historical and future cash flows, as well as business plans, can also be part of the assessment. Independent mortgage brokers expect that borrowers will be asked to provide bank statements, tax returns and rental accounts. This means that in the vast majority of cases, automated loan approval processes will no longer be sufficient. With increasing complexity, a manual process will likely be necessary, meaning that fewer lenders will be available to borrowers. While the stricter rules on ICRs and interest rate stress tests came into effect in January 2017, changes in the underwriting standards for portfolio landlords will not be implemented until the end of September 2017.

The changes in underwriting standards to portfolio landlords have received less attention in the media than the increase in stamp duty or the reduction in mortgage interest tax relief. This might be because the public image paints the 'typical' BTL borrower as an individual with one or two BTL properties only. However, this is not necessarily accurate. Assuming that stricter rules for lending to borrowers with multiple BTL properties would only impact a minority of the business is a misjudgement. Data from Shawbrook Bank shows that among its clients, a clear majority of borrowers count as portfolio landlords both amongst private investors, and those with Ltd company structures.

Assuming that other lenders also extend a substantial share of their BTL mortgages to portfolio landlords it is clear that the change in underwriting standards will have a large impact on the market. Potential borrowers will have to look for a reliable lender who is capable of performing the necessary checks and assessments with adequate speed and accuracy. Lenders on the other hand will have to adjust their processes in order to be able to continue to offer their services to customers, while at the same time complying with the new regulations.

3.4 Brexit and the BTL market

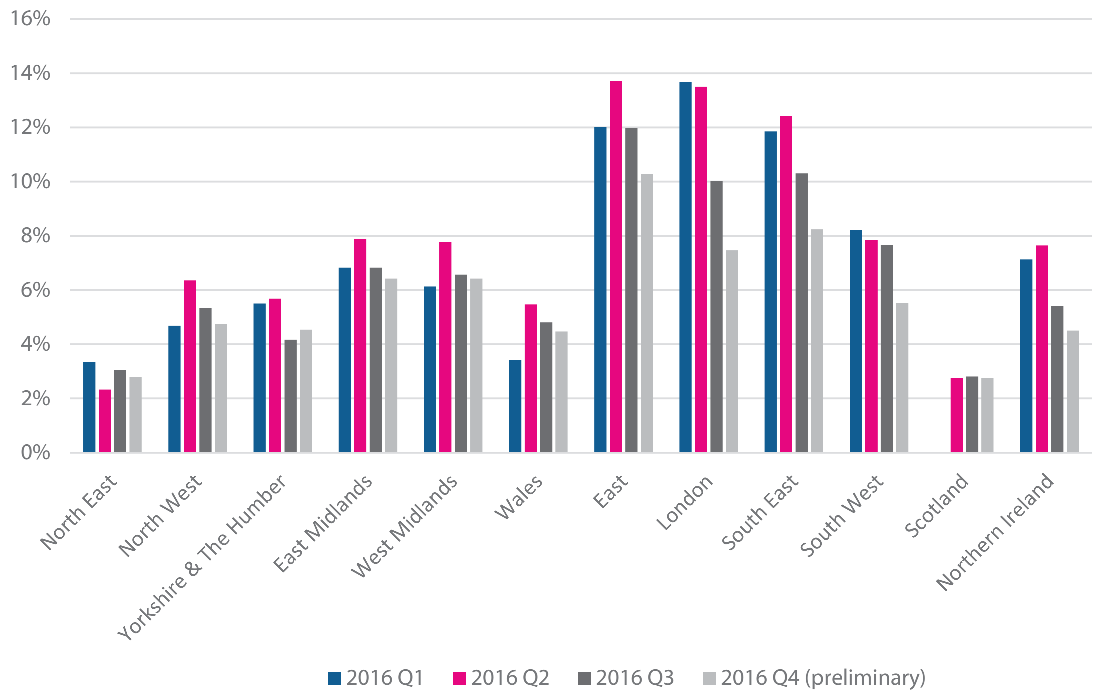
Besides a number of changes in rules and taxes regarding the BTL sector, 2016 also saw the UK voting to leave the European Union with far reaching consequences for all sectors of the economy. The property market in general, and the BTL sector specifically, has shown resilience in the second half of 2016. Figure 8 shows the annual growth rates for house prices by region. While growth has slowed compared to the first two quarters of the year, house price inflation remains well in positive territory in Q3 and Q4 for all regions and only slightly below levels seen before the referendum. London has experienced one of the largest falls in growth rates as the capital is a lot more exposed to international investor sentiment than other regions. It is also important to keep in mind that other factors besides Brexit have had an effect on house price growth between Q2 and Q3. The changes in stamp duty mentioned above and the falling levels of activity in the market are also important drivers of house price growth, unrelated from the EU referendum.

Going forward, the course and the outcome of Brexit negotiations will have notable effects on the wider UK housing market as well as on the BTL sector in a number of ways. The Prime Minister has repeatedly said that obtaining control of the UK's borders is her top priority, implying the end of the free movement of labour from Europe. Less immigration will reduce demand for housing and lead to weaker price growth in certain areas and for certain types of properties. Data from the Labour Force Survey shows that two-thirds of non-European Economic Area born migrants who have been in the UK for less than five years live in rented accommodation, while the share rises to almost 80% for EEA-born migrants. If the UK closes its borders to these people, rent levels could fall leading to lower income for BTL landlords.

However, migrants are also an important part of the labour force, especially in the construction industry. Current data shows that around 12% of the 2.1 million-strong construction sector workforce are EU nationals. The distribution of EU migrants among the construction sector workforce is highly unequal across regions, as shown in Figure 9. In London more than one in three is EU-born. The East of England and Northern Ireland follow with shares of 10% and 8% respectively. Reducing immigration is likely to further exacerbate the skills shortage in the construction sector – one of the most important bottlenecks for increasing housing output.

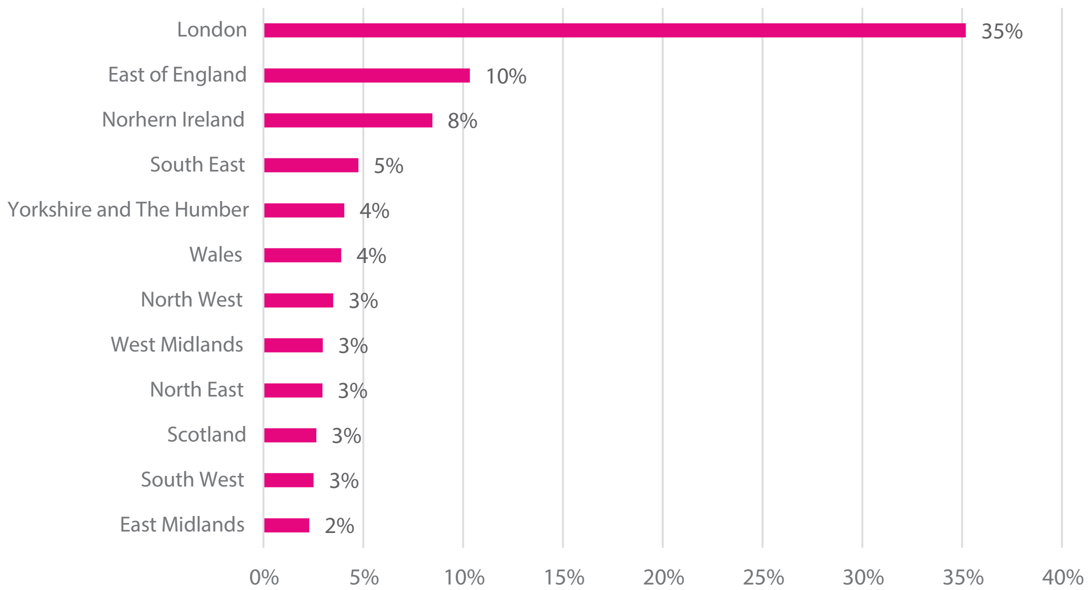
On a more general level, Brexit is expected to lead to slower economic growth in the UK in the short- to medium-term. While it has to be kept in mind that there are considerable economic and political uncertainties over the coming years, most forecasters agree that weakening consumption growth due to households adapting to a period of very low real income growth will have a detrimental effect on overall economic growth. Higher inflation – a result of the weaker currency – will erode consumers' real incomes and potentially lead to falling consumer confidence and reduced transaction activity in the housing market. An overall slowdown in the housing market would also affect the BTL market through reduced capital gains and possibly lower rental incomes. Predicting the impact of Brexit further in the future is highly dependent on the outcome of the negotiations between the UK and the EU as well as how quickly the UK can settle into its new role in the global order.

Figure 8: Regional house price growth, annual rates



Source: ONS, Land registry, Cebr analysis

Figure 9: Share of EU nationals in construction sector workforce, by region



Source: Labour Force Survey(Q2 2016), Cebr analysis

4. CONCLUSION

Since its inception in the mid-1990s, the Buy-to-let market has shown significant growth and has become an important segment of the UK housing market.

Buy-to-let is vital for the private rental market, itself a housing tenure filling an important gap left open by declining home ownership rates and the decrease in social housing programmes. This trend is set to continue as private renting is no longer exclusively a temporary solution for people saving up for a housing deposit. Due to a variety of reasons more households are renting privately for longer than 20 or even 10 years ago. For students, young professionals, or people who move temporarily for work, the private rental sector offers much-needed flexibility. Others rent out of necessity rather than out of choice as they are locked out of the housing market due to unaffordable house prices.

BTL activity has been especially pronounced in London, where demand for rental property has been strong for years. For this reason, the size of the BTL sector in London is much bigger relative to the residential property market, unlike in all other regions where the share of residential mortgages and BTL mortgages is approximately even.

With Brexit negotiations underway, it is possible that demand pressures in some areas will ease beyond 2019 if the government makes good on its pledge to reduce immigration substantially as fewer people come to the UK to work or study. Demand from households, who can't afford to buy a house, is set to remain strong as the continued shortfall in the supply of housing will support house price growth in the years to come. This is especially true for those regions where we expect strong house price growth in the future such as London.

Aside from Brexit, the BTL market is undergoing some transformative changes. In a bid to strengthen the position of first-time buyers, the government has taken a number of measures in order to tilt the scales in favour of first-time buyers and against BTL landlords. After the general overhaul of the stamp duty system in 2014, the government added a 3 percentage point surcharge on second homes in April 2016. This increased the upfront cost for potential BTL investors substantially. Moreover, starting from April this year, BTL landlords will no longer be able to reclaim the full amount of mortgage interest paid on their tax return. Until 2020, the amount of mortgage interest that can be deducted will be gradually reduced to zero and replaced with a 20% flat rate rebate. This move will impact the profitability of BTL investments for a large number of private landlords.

The tightening in underwriting standards for lenders will also have an impact on the industry. However, as the BTL sector grows in significance, it is important that regulators make sure that all parties involved take risk assessment seriously and carefully evaluate the profitability of the investment in order to maintain the integrity of the market and the financial system as a whole. While recent developments in the sector certainly pose challenges for private landlords, strong demand for rental units and capital appreciation still work in favour for those carefully selecting a Buy-to-let property as an investment for the future.

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