



OPPORTUNITY KNOCKS?

Institutional Investment
in the Private Rented Sector in Ireland

Prepared by Professor ADH Crook
and Dr Steven Rowley, University of Sheffield

Acknowledgments by Threshold

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Tony Crook and Steven Rowley

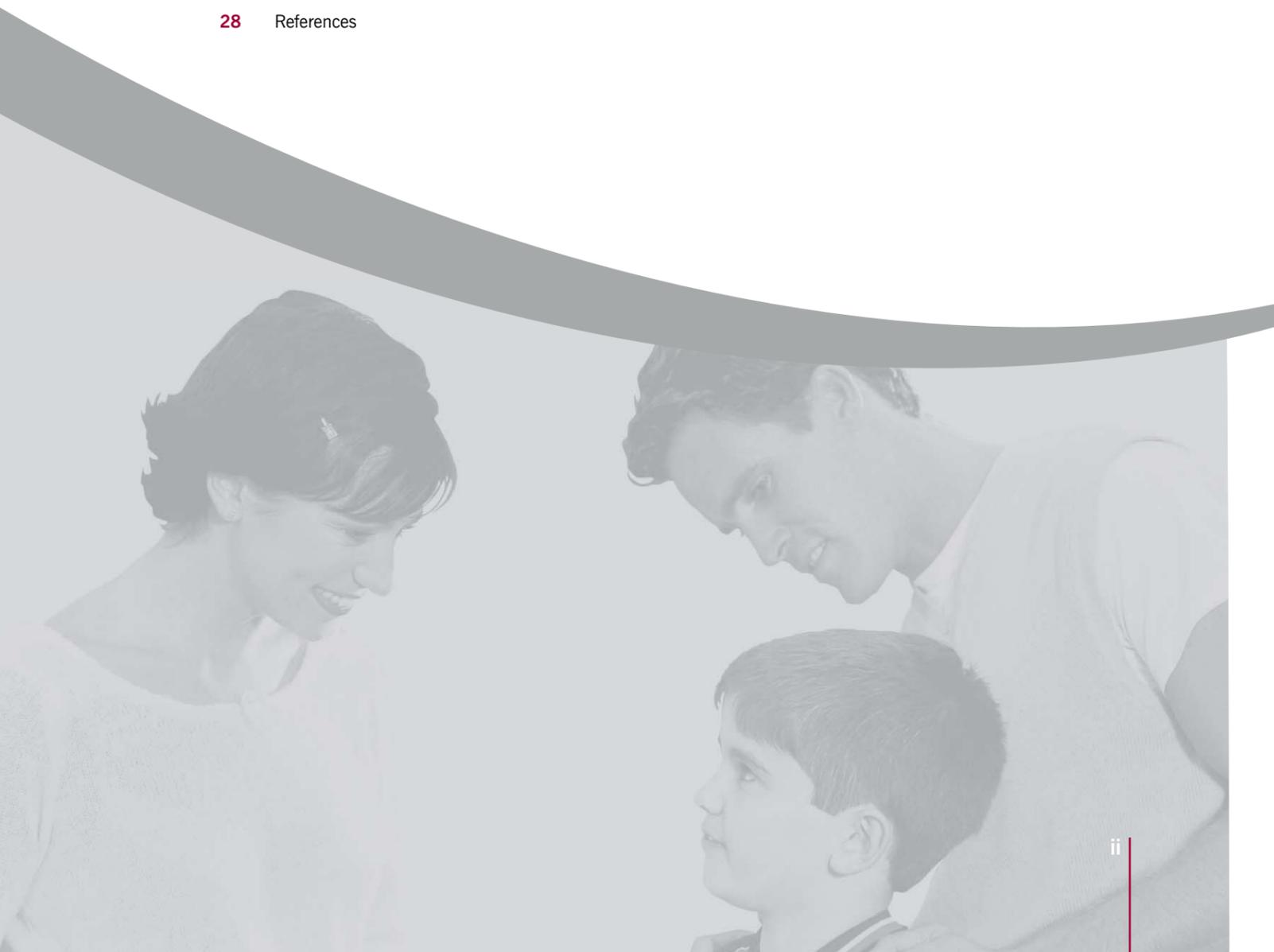
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Foreword

Threshold welcomes the opportunity to launch this important contribution to thinking on the development of the Private Rented Sector. In particular we would like to thank the Irish Bankers Federation and the Irish Mortgage Lenders for their foresight in being willing to consider an area of housing not previously seriously considered by financial institutions from an investment perspective. We are very supportive of the potential for institutional investment in the private rented sector, provided of course that it includes provision for those on low incomes, and that Government also plays its part in extending social housing provision.

The Private Rented Sector in Ireland has grown at an unprecedented rate in the last six years for reasons that are well documented. Unlike countries such as the Netherlands, France and Sweden, Ireland has no direct investment by financial institutions in the sector which makes the examination of this issue particularly relevant.

While improving the supply of private rented housing generally is an objective supported by Threshold, our priority is the provision of good quality, secure and affordable rented housing at the bottom end of the market. In spite of an anticipated build of close on 80,000 housing units next year, supply at the lower end of the PRS market remains a problem. Threshold is particularly concerned that low cost rental housing be provided for people who are experiencing affordability problems. Additional housing is needed to meet this demand and the potential contribution of institutional investors in this provision must be examined.

The supply of housing in the PRS market is currently dominated by small-scale individual landlords with one or two properties, motivated in the main by capital gain. This leaves the sector vulnerable to a decline in property values or other external shock such as rising interest rates. Furthermore the variable quality of supply and management of properties in the sector is a cause of concern. This is particularly so as poor quality is almost exclusively at the lower end of the private rented sector. The benefit Threshold perceives from the involvement of institutional investors in this end of the market is the overall improvement of standards of quality provision, an increase of supply and the introduction of professional management practices.

While interest to date in the sector by financial institutions has been non-existent, there are fundamental changes occurring not only in the overall relevance of the PRS within the housing market but legal change which promises positive outcomes for a more efficient and certain management of the sector by Government. The Residential Tenancies Act 2004, which was introduced earlier this year, allows not only for the collection of data generally on the sector, particularly on rents (of particular importance for institutional investment) but also provides for a measure of security of tenure for tenants and a speedy system for the resolution of disputes. It is believed these measures will improve the public perception of the private rented sector as a form of investment.

The recently announced Rental Accommodation Scheme designed to promote accommodation based provision in place of the current rent supplement payment provides one possible route for the engagement of financial institutions in the sector through PPP vehicles. Such a development would be welcomed provided and only provided that other aspects of the scheme are satisfactorily worked out.

Part V also of the Planning and Development Act 2000 could be used to a greater extent in the provision of social housing if a model of UK style Housing Associations in partnership with institutional investors were developed to maximise this potential. This report presents Government not only with an analysis but also positive proposals on how institutional investment could be utilised to promote housing good. We must conclude however that any such involvement must also target provision of housing at the bottom end of the market. We must also conclude that any contribution by institutional investors can only ever be part of the solution. The housing needs of those currently on the housing waiting list or in receipt of rent supplement can only be met by significant investment by Government in social housing provision.

It is up to Government to determine how the cost of providing incentives to private investors to invest in low-income housing compares with the cost of providing such housing itself, and therefore to determine the best use of its own resources.

Aideen Hayden, Chairperson of Threshold.

Executive Summary by Threshold

This executive summary has been prepared by Threshold and does not purport to reflect the views of the authors or the project advisory group (listed in acknowledgements). Threshold would again like to thank them for their contribution to this report.

Threshold – national housing organisation

Threshold, a nationally based housing organisation established over 25 years ago, has worked on all aspects of the housing system in Ireland. Although founded as an organisation dealing with the private rented sector, Threshold has contributed to all aspects of housing policy – private rented sector, social housing, homelessness, housing legislation and housing rights.

Regional centres in Cork, Dublin and Galway provide expert information and advice to tenants and landlords in the private rented sector. The Access Housing Unit is a unique placement service that assists people who experience homelessness to move into private rented accommodation. One of Threshold's most successful and landmark programmes is our Gilabbey Court Housing Project in Cork City. This project helps families and couples to get on the housing ladder by creating an opportunity for them to save for the deposit to buy a house through careful financial management and sensible budgeting.

While advice, information and practical projects can assist in the short-term, it is also crucial to identify the causes of the problems and identify solutions. Through its Research Unit, campaigns and educational programmes, Threshold has contributed significantly to the evolution of housing policy and legislation and to the understanding of the role and significance of housing in Ireland. Threshold's knowledge of the housing system is widely acknowledged and actively sought by public representatives, policy makers, the media, community organisations and others interested in housing matters.

Why this Research?

This research study was commissioned by Threshold to investigate the potential of Irish financial institutions investing in private rented housing market.

Threshold is acutely aware of the need to strengthen Ireland's private rented sector. While the size of the private rented sector increased during in the nineteen nineties, it is still only 11% of Ireland's housing supply, acutely low for a country with a large proportion of young adults and a fast growing economy.

Up to the nineteen eighties, the sector was characterised generally by an ageing housing stock, often poorly maintained. This saw some improvement with the introduction of Section 23 and Section 27 schemes allowing generous capital expenditure and income tax reliefs on accommodation to let. Regulations on minimum standards and other changes to the landlord and tenant code followed, such as the introduction of rent books and obligatory registration of landlords. While the increased housing build of recent years has undoubtedly led to significantly better quality accommodation being available to the sector, Threshold remains concerned that poorer stock is unfortunately still an issue at the lower end of the market. In addition, the fragmented, small-scale character of supply has impeded the adoption of professional management practices.

Threshold has campaigned actively since its foundation, and the publication of its report 'Private Rented: The Forgotten Sector' in 1982, for legislative reform to ensure justice for private rented sector tenants in Ireland. Threshold sincerely welcomes the introduction of the Residential Tenancies Act 2004, which makes historic changes to the relationship between landlords and tenants.

It is highly likely that if financial institutions were to invest directly in the private rented sector, good quality private rented accommodation would increase and good management practices would become the standard. Yet few incentives have been put in place to promote investment in the Irish private rented sector by financial institutions. This is in contrast to the situation in countries such as the Netherlands, France, Sweden and to a much lesser extent, Britain. Threshold is committed to pursuing the changes necessary to ensure that the private rented housing market is an attractive, sound investment for financial institutions in Ireland.

“Threshold is committed to ensuring that good quality private rented accommodation is made available at the lower end of the market.”

Threshold, with financial support from the Irish Bankers Federation and Irish Mortgage Council commissioned this study to look at the potential for Irish financial institutions to enter the private residential rented market as owners, especially at the end of the market providing for households on modest and low incomes. Professor Tony Crook from the University of Sheffield, a distinguished expert on the economics of housing investment in the UK and elsewhere was commissioned to undertake the research. Together with his colleague Dr Steven Rowley he investigated a variety of information sources. The researchers were guided by an advisory committee with members from a range of backgrounds.

Irish housing experts in the public and private spheres gave extensive interviews to the researchers. Senior financial officers in Irish banking institutions also significantly engaged with the research. Critical inputs and suggestions were made by participants from banking institutions at a seminar on institutional investment organised as part of this study. To supplement the qualitative information, the researchers sought out and analysed available financial performance information on the sector. They also took into account recent Irish and UK government initiatives which are affecting the market.

Key Observations

Financial institutions will only become involved in directly investing in the private rented sector when the following necessary conditions are in place:

- **Sufficient and reliable data must be made available on the rent and yields available through investment in the sector. This information is needed both for existing investors and those considering investing in the private rented housing market.**
- **An appropriate intermediary vehicle (like Real Estate Investment Trusts in the United States) must be established that would make it easier for financial institutions to invest in the sector. This tax transparent property investment vehicle would allow financial institutions to invest in residential property without involving direct contact between institutions and tenants.**

Research findings

At present decision-makers in financial institutions are highly involved in supporting the private rented housing market through the provision of mortgage offers (e.g. buy-to-let mortgages) to people investing in the sector. However, the conditions have yet to be created that would support institutions to own businesses in the sector.

The costs of managing and maintaining properties, even if done through a third party, are perceived to be high because landlords of residential properties have greater service obligations than commercial property landlords.

Also the savings achievable from large scale transactions are unlikely to be realised as residential properties and purchase opportunities are typically modest in size. Tax interventions to attract institutions into the sector are unlikely to be introduced by government.

Data about the private rented sector is extremely limited. What is available suggests that capital gains on investment from residential rental properties are competitive but long-term income returns are low. It is the flow of income returns that provides the benchmark for investment decisions by financial institutions.

An important observation made by senior financial officers at the seminar on institutional investment was that the private rented sector would benefit from a legislative framework. Threshold welcomes the introduction of the Residential Tenancies Act 2004 which will provide a comprehensive, regulatory process for the sector.

Also the development of a rent and yields index is considered crucial for attracting institutional direct investment. The Private Residential Tenancies Board established under the Residential Tenancies Act 2004 will gather information on market rents based on national registry of tenancies that could be used for this purpose in the future.

Recommendations

A lack of information on residential investment returns coupled with the absence of investment performance benchmarks increase the risk of investment. To address this:

- **Commercial property organisations could collect more disaggregated data on rents and yields in the private rented sector. This could act as a guide for existing investors and those contemplating entering the market.**
- **The Private Residential Tenancies Board should ensure that information on the private rented sector collected by them (e.g. market rents) is made publicly available in an accessible format.**

The Department of Environment, Heritage and Local Government plans to provide rental housing for people on rent supplement (i.e. Government support for tenants on low income) through the new Rental Accommodation Scheme. Rental housing will be provided partly through existing stock but also significantly through new-build Public-Private Partnerships (PPPs).

- **The Department of Environment, Heritage and Local Government is piloting projects that aim to provide subsidised rental housing through Public-Private Partnerships (PPPs). These should be monitored so that institutions can assess whether they are an investment proposition.**

Part V of the Planning and Development Acts 2000-2002 provides that up to 20% of any new housing development may be set aside to provide social and affordable housing. Housing associations may get involved in developing land set aside for this purpose.

- **The Department of Environment, Heritage and Local Government and Department of Finance should explore ways in which institutional finance could be attracted to fund social housing through Part V of the Planning & Development Act 2000-2002, based on a UK Housing Association style of organisation:**
 - **Some tax changes and a rent index to create benchmarks would most probably be needed to attract investors to middle income private rented housing.**
 - **Attracting debt funders into low income housing would require massive state investment through a regime of grants and public debt, along with a clear regulatory framework to give confidence to lenders and provide stability.**

A tax transparent property investment vehicle could allow financial institutions and others to invest in residential property without dealing directly with tenants.

- **The Department of Environment, Heritage and Local Government and Department of Finance should examine the potential for special purpose vehicles to promote investment in the private rented sector, specifically the 'Property Investment Fund' currently being investigated by the UK government.**

More data and analysis on the private rented sector could greatly facilitate financial institutions in their deliberations on investment decisions.

- **The Department of Environment, Heritage and Local Government should examine ways of enhancing the availability of relevant data and analysis that could approve additionally useful for financial institutions in assessing the potential for investment.**

While the above recommendations are vital for institutions to consider entering the private rented sector, they are not sufficient. The requirement for low cost rental housing can only currently be met through increased investment in social housing.

“The Department of Environment, Heritage and Local Government and Department of Finance should examine the potential for special purpose vehicles to promote investment in the private rented sector, specifically the ‘Property Investment Fund’ currently being investigated by the UK government.”

1: Introduction: aims and objectives of project

1.1 Aims and Objectives

This report was commissioned by Threshold to explore the barriers to greater institutional investment in the private rented sector of the housing market in Ireland. Threshold has a particular interest in identifying the scope for equity funding due to their work with landlords who provide housing to those in housing need. They consider that the evidence of rented housing shortages and of rising house prices and rents suggest that additional private rented housing is required to help meet need as well as market demand.

Small scale individual landlords currently dominate supply. Institutional involvement would prompt a longer term investment view of the rented sector and a more professional and responsible management approach.

The authors were commissioned to undertake research into the prospects for attracting additional equity and debt funding into the Irish private rented sector, because of their experience in conducting research into the sector in the UK and elsewhere, including on institutional funding – and also because of their experience in examining the funding of commercial property in the UK (see for example: Crook, 1998, 2000, 2002; Crook, Hughes, & Kemp, 1998; Crook & Kemp, 1996, 1999, and 2002; Henneberry, & Rowley, 2000)

1.2 The research process

The original intention was to conduct a two-stage enquiry, leading to a final report with recommendations. In the first stage, a scoping study was to be employed, involving a review of the available literature and interviews with key informants in government, the industry, and landlords' organisations. This was to provide a framework for the second stage; personal interviews with a sample of senior managers in a range of Irish and overseas financial institutions to collect qualitative data on current funding, barriers to greater funding, and ways of overcoming them.

Stage one was conducted between January and February 2002 (and reported to the project's advisory group in March 2002), but the later stages were modified in the light of its findings.

The results of the first stage suggested that rates of return offered by residential property investment were too low to attract the major financial institutions to equity funding. It was agreed to analyse the evidence in more detail before conducting interviews with financial institutions. This was carried out as a desk exercise between April and May 2002, assembling and analysing a range of secondary data and other evidence. This reported that, although income returns were low, total returns, far from being uncompetitive, were comparable with total returns from commercial property, allowing for risk and liquidity. The results of this stage were reported to Threshold in June 2002.

Due to difficulties getting insights through interviews with representatives from financial institutions it was agreed that the research should instead focus on identifying overseas institutions operating in Ireland but also with experience of overseas housing markets in the rest of Europe and in North America where similar institutions funded private landlords. A short survey was undertaken to identify why, in the light of that overseas experience, these institutions were not funding the sector in Ireland. That exercise was carried out between August and September 2002. The evidence from an earlier version of this report and additional evidence from two key experts were discussed at a policy forum in October 2003. Further discussions with Threshold in light of the draft final report of June 2004 prompted a change in emphasis. In light of the findings it was decided that the final report should concentrate on measures to encouraging institutional investment in the private rented sector. It is these measures that are discussed in the later chapters of this report.

1.3 Structure of the report

There are five remaining sections:

- The first, in Chapter 2, describes the demand and supply position in the PRS in Ireland;
- Chapter 3 examines the potential returns available from the PRS;
- The current level of institutional investors' involvement in the PRS and the barriers preventing further investment are discussed in chapter 4.
- Chapter 5 investigates what measures could be implemented to increase institutional investment in the PRS.
- The final chapter discusses the conclusions from the research and examines the future of institutional investment in the private rented sector in light of the measures identified in the previous chapter.

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2: The supply and funding of private rented housing in Ireland

2.1 Introduction

The published evidence on the private rented sector in Ireland is relatively sparse. With the exceptions of the report of the Government's Commission on the private rented sector, the recently published study of landlords in Dublin commissioned by Threshold, the 'Bacon' reports, a number of studies undertaken within government departments and a small number of other studies (mainly commissioned by Threshold), there is little published evidence on the supply side of the sector (Department of the Environment & Local Government, 2000; Memery & Kerrins, 2001; Bacon, 1999; Department of Environment, 1996). There is very little indeed on institutional involvement.

Hence, in addition to examining this literature and a range of official documents related to taxation, interviews were undertaken with a number of key informants from government departments, financial institutions, and the property industry. These were very valuable and included both personal (mainly) and telephone (some) interviews. Organisations were helpful and staff were generous with their time. The interviews were undertaken on the basis of confidentiality and it was agreed not to quote informants, neither personally by name or by reference to their organisations. Hence the views of those interviewed are not attributed to their source.

During this stage of the research we interviewed key informants including those from government, financial institutions and the property sector. These were face to face interviews conducted in early 2002.

Analysis of the interviews and supporting documents, either supplied by the interviewees or subsequently identified, falls into three main headings:

- Demand and recent new supply: overall picture
- Financing individual landlords' investment in private rented housing
- Taxation and other government measures

2.2 Demand and new supply: overall picture

There are two key issues which shape the PRS in Ireland:

- The vast majority of landlords are small scale individuals; there are very few companies; there are very few non Irish landlords; many landlords entered sector for the first time in the 1990s.
- Private rented housing supply has increased significantly in 1990s, fuelled by capital allowances and by other tax incentives and also by investment targeted at achieving capital gains;

Demand

According to the 2002 census in Ireland, between 1991 and 1995 just over 15,000 dwellings were built for private rented accommodation. In the period 1996-2002 this figure rose to 31,800 dwellings. This is a significant increase in supply although both figures are approximately 16% of total new house building. Over 22,000 new flats or apartments in purpose built blocks have been constructed since 1996, 31% of the total supply of this property type (total supply of 70,474). 48% of the total supply is now in the private rented sector. Therefore there has been a significant increase in the availability of purpose built rented property since 1996.

The upward trend in the availability of rented property in the 1990s was associated with a big increase in population and a lot of the increase was in household forming age groups, for example those seeking to move out of their parent's house. This contributed to the growing demand for rented accommodation. The

economic boom led to immigration, including Irish workers returning from abroad, and a significant increase in student numbers coupled with a growth in asylum seekers has also fuelled demand. Although renting used to be thought of primarily as a transitional tenure (between living in a parental home and owner occupation), it is now recognised that renting fosters flexibility in labour markets and can be helpful in nurturing economic growth.

Major problems arise from the shortage of public sector units and the significant lack of affordable housing. A lack of labour mobility is just one of them. Nor has the private rented sector catered very well for middle income groups – those in between local authority housing and the top of the rented housing and the owner occupied market.

A particular policy concern has thus been the growth of households at the 'bottom end' of the private rented market, including households with children and those dependent on Supplementary Welfare Allowance (SWA). Evidence suggests that this sub-market is increasingly dominated by rent supplements supporting households in private rented accommodation of varying standards unable to pay rent from their own resources. The Department of Social Welfare contributed €331m per year in 2003, covering 60,000 claimants within the scheme. Rising rents have been increasing this bill. The number of recipients has not increased substantially since 1998-1999 and so increased rental levels have been the drivers of extra government costs. A number of interviewees argued that significant public funds were spent on these supplements and that it was important to ensure that the funds secured more and better quality rented housing.

General Supply

Research published by Threshold suggests that 96% of private rented sector (PRS hereafter) landlords in Dublin were individuals, the majority of whom own only a single investment property (Memery & Kerrins, 2001). The remaining 4% were classified as companies (although it can be calculated from other data in the report that these own 10% of the total stock of private rented housing). The limited available evidence suggests that financial institutions have almost no equity investment in this part of the housing market, but have substantial loan books. There is no evidence of significant equity investment from overseas, including from overseas financial institutions. There is, however, evidence of overseas debt funding. This supply side picture is not unique to Ireland. Many other countries, including Australia, Canada, UK, and the USA have a PRS where landlords are largely part time and small in scale, managing their own modest portfolios (Crook, 2000).

Many individual investors are in traditional employment, such as policeman and teachers, and have borrowed against the large increases in the value of their own property. One to three bed apartment properties are the most common form of investment. The large increase in demand for investment properties has fuelled rising prices and forced many who would normally have bought a property into rented accommodation.

The growth in supply since the late 1980s appears to have been stimulated initially by Section 23 tax incentives (especially in relation to apartment blocks) and this brought new investors into the market as landlords for the first time. This growth was subsequently fuelled by rapidly rising house prices, leading to investors buying property primarily for capital appreciation. Investments are highly geared: landlords have received around 80% mortgages and so needed to put in only 20% equity. Often rents are not sufficient to cover mortgage and letting costs and investments rely on capital growth for long term returns. Some interviewees argued that many people in Ireland with spare money to invest put it into property and were not very price sensitive when acquiring properties. This has led to excessive demand. Private investors have been buying everything from apartment dwellings to standard semi-detached properties in

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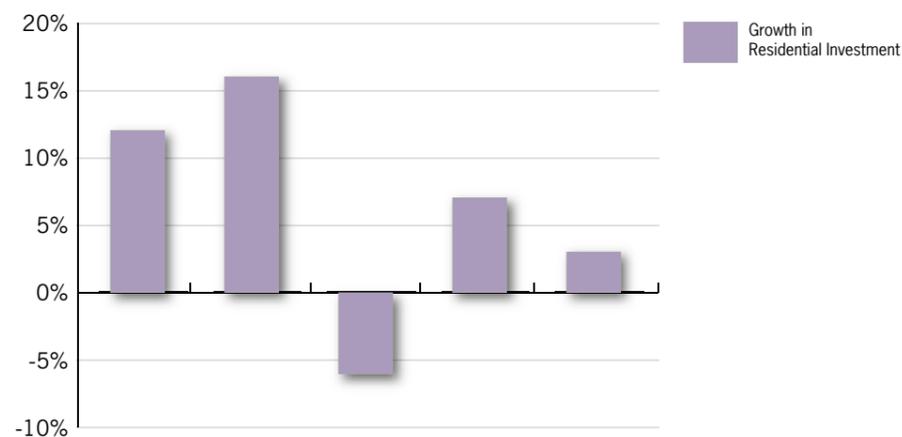
suburbia and letting them. Investors were thus crowding out first time buyers and were hence, and ironically, securing tenants by effectively making property unaffordable for them to purchase.

Concern about the implications of these rapidly rising house prices for owner-occupiers (created as much by supply side constraints as by investor demand) and also for the state of the construction industry has dominated recent policy decisions. There has in particular been concern about competition between 'one off' purchases by individual investors and first time buyers with private investors crowded out traditional owner-occupiers. It was a market in a booming economy with a tightly constrained supply. There has been a willingness on the part of the government to use tax measures to shape the market. In the absence of monetary control, interviewees pointed out that fiscal measures are the main instrument available for the Irish government to influence the market.

In 2000/01 the Government tried to steer the market in favour of first time buyers and hence squeeze private investors out of the market in order to reduce competition for the available supply of new homes. The removal of full mortgage interest deductibility and the imposition of higher stamp duty rates on investment property appeared to have affected investment in the private rented sector and, it was alleged, pushed up rents - therefore (and ironically) making it more difficult to save to buy. The aim of the government was to remove an unnecessary investor incentive from the market. Examples were quoted of developers holding back specific developments until after the December 2001 budget measures came through, restoring interest deductibility and reducing stamp duty. Indeed it was argued that these 'Bacon measures' (names after the author of the reports upon which the policy was based) eliminated investor demand 'overnight', freezing house prices, so significantly reducing total supply from the second hand as well as new supply markets. The effect of the fiscal measures is apparent in figure 1. Figure 1 shows the year on year growth on investment by private landlords in the PRS.

It was estimated that as much as 25% of new supply had been bought by landlord investors and that it was not untypical for up to 30% of new estates (houses as well as apartments) to be sold to investors prior to the 'Bacon measures'. It was also argued that a number of developers pulled out of the market completely because of these tax changes and also because of changes to the planning system which required a contribution of up to 20% of the development site to affordable housing (Part V of the Planning and Development Act 2000). 21% of vendors who were selling properties in 2001 were selling investment properties. This combined with the very low levels of investor demand was a contributing factor to the strength of rental inflation, running at 15% pa in 2001.

Figure 1: The Growth in Residential Investment in Ireland 1999-2003



Source: RICS European Housing Review 2004

There is evidence, nonetheless, that new completions, after the tax measures on investors, have been purchased by owner-occupiers and not private investors. Distribution of lending moved towards first time buyers in the 18 months up to the end of 2001. In the second half of 2001 there was faltering investor demand as the result of the Bacon measures, reinforced by the economic slowdown. Therefore the forced decrease in investor demand and increase in supply during 2001 slowed price rises. The level of unsold stock was significant and was concentrated in the apartment sector. It reflected a deficit in investor interest shaped by the tax changes.

Interviewees also argued that the December 2001 budget, which rolled back the tax position of investors with respect to tax deductibility for interest payments and also stamp duty, to the 'pre Bacon' position was due to pressure from the construction industry. The 'penalising' 9% stamp duty rate was replaced with a tiered rate commencing at 0% up to maximum of 9% at the highest level. Interest arising on or from January 2002 on borrowed monies employed in the purchase and improvement or repair of rented properties by an individual, partnership or company was allowed as a deduction for tax purposes. These changes have had the effect of providing a stimulus to the investor market.

2.3 Supply – low income end of market

Very few investors have bought expensive property. Mortgage and other evidence suggests they are buying 1 to 3 bedroom apartments and houses in the price range of €200,000 - €300,000, both second hand and new. Several interviewees commented that there was now a 'vast' supply of similar properties without the infrastructure to back them up. Nor is there evidence of any significant investor interest at the lower price (and quality) end of the market.

There are clearly significant policy implications stemming from the lack of 'low income' supply and a key policy issue is to encourage additional supply of rented accommodation at the middle to bottom end of the market, especially in relation to the latter and specifically targeted at SWA tenants. Interviewees argued that 'no one' is interested in this sub market. Some of the low quality supply was refurbished and renewed using S23 capital allowances resulting in a redistribution of the supply of some low quality property to the mid rented market. Properties that once housed low income groups are now no longer affordable to these tenants. In addition, a significant proportion of rented housing used to come from owner-occupiers letting out rooms and taking in students and other low income groups to supplement their incomes. A large proportion of that was withdrawn as incomes rose and it was no longer necessary to supplement finances.

There was also a specific concern over student accommodation. One of reasons why Dublin has so much pressure on rented accommodation is the increase in student numbers. Some interviewees would like to see an increase in 'on campus' accommodation, using tax incentives.

2.4 Borrowing

Mortgage data indicate that investors appear to be 'ordinary' people in 'ordinary' jobs. Evidence in early 2002 suggested that landlords were then able to get about 80% mortgage on valuation, so needed to put in only 20% as equity (sometimes 90% loans were available for the first investment property). This does not necessarily mean landlords have to find this equity as many recent entrants to the investor market are using increases in their own home to finance a mortgage on a second (investment) property. This means that new landlords (and existing ones wanting to enlarge their portfolio) do not need additional equity to become an investor; they can lever in the equity from their own house. But many investors will use private savings as equity, typically, €20,000 to pay for stamp duty and to undertake refurbishment. Examples quoted included policemen, teachers, and bank officials all investing in properties based on the value of their first houses and the capital rise expected from their investments.

“There are clearly significant policy implications stemming from the lack of 'low income' supply.”

Interviewees considered that these landlords were looking for capital appreciation and an additional income in pension years (this is consistent with the findings from the Threshold commissioned study of Dublin landlords). Rents are high enough to pay mortgage and letting costs. A net income yield of 7.5% pa was said to be achievable in Ireland - not net of interest costs, but net of management and fit out costs (but see later evidence in Chapter 3). Landlords tend to employ property management companies for the equivalent of a month's rent but some manage their own properties in their spare time. In terms of total return, landlords have earned an average of 20% pa capital appreciation since 1994. Given the extent of capital appreciation, individual investors are not as concerned with income growth as financial institutions, provided that rents cover interest and other running costs. Hence, private investors may 'crowd out' equity investment from financial institutions, since they are not seeking a target income or total return on their investments.

2.5 Lending

Funding has come from mainstream banks and building societies. There is no one specific bank that funds private landlords. Lenders include the large highly diversified banks, the single product banks (which are the demutualised building societies), the two remaining building societies, and a number of smaller banks that are involved in the commercial sector.

Banks have adopted a quite careful approach on the basis of loan to value ratios and the ability of rents to fund interest. To the extent that banks have been worried about their exposure and the possibility of default they have based mortgages on lower rents. Falling interest rates have reduced this risk. At the peak, a third of mortgages in 1998-1999 were to investors (it was also the peak in house prices). Attitudes of lenders changed in mid 2001 and they have become more cautious to ensure that they do not over-lend to owner-occupiers and developers as well as to investors. As a result the maximum loan to value ratio at the beginning of 2002 was 80% for private and commercial landlords and they were charged a slightly higher rate of interest than owner-occupiers. However a 90% loan to value ratio was available on first residential investment properties and an owner-occupier interest rate was obtainable on a first investment property.

The Central Bank of Ireland examines all banks' exposure to property. Irish banks were alleged to be more cautious than, for example, UK banks were during the 1990s property boom and bust. Interviewees argued that the total lending book of the banks to investor landlords looks cautious but it is not clear what the practices are at the margins. Overall events in the last 5 to 7 years did cause the central bank some concern. It carried out an in depth study on lending policy to owner occupiers and at one stage it asked banks to watch their (then) loan to value ratios of 90% as they were worried about banks being over-stretched. Lending to investor landlords is considered prudent lending from the central bank's point of view

Overseas funding appears very limited. The (then) Bank of Scotland was the only lender from outside Ireland to enter the residential investor market during the late 1990's. It offered lower rates, about 1% less than then being currently charged by Irish banks. It was very selective but Irish lenders were quick to react to the competition and reduced their interest rates. A similar situation occurred on the deposit side when Northern Rock entered the market.

2.6 The Impact of taxation measures

The Irish government has used fiscal measures in an attempt to control the supply side of the PRS. The various measures altered, introduced and repealed (such as S23 capital allowances, stamp duty and interest deductibility) had a significant effect on the PRS and its balance with the owner occupier sector. This policy achieved many of its objectives with construction activity at record levels since 1994 and still rising (2002).

Section 23 was viewed as the key to unlocking investment and the effect of the policy was remarkable and viewed as one of the contributory factors to the boom of the 1990s, introduced at a time when tax rates were higher and capital allowances gave greater benefit in tax mitigation. S23 was repealed in many areas in an attempt to slowdown the PRS and is now essentially an urban renewal tool. Capital allowances are still available with respect to capital expenditure on refurbishment of PRS stock.

It was also suggested that S23 was inflationary and that allowances had been capitalised into higher land and property prices. There has also been a concern that many of the properties constructed under S23 were small and poor quality dwellings in bad locations.

The regulations governing institutional involvement in residential and commercial property offer little in the way of benefit when compared to investment in alternative assets. Pension funds are exempt from paying tax on income for direct investment, although they pay stamp duty on transactions. The tax regime is already favourable to pension and life funds and key informants suggested that there would be no additional relief to attract institutional investment in the private rented sector. The tax regime is no major barrier to institutional investment in the PRS. It should be pointed out however that for pension funds, indirect investment does carry a tax penalty, compared with direct ownership. Since institutions are not disposed to own residential lettings themselves (see below), whereas they do own commercial property, indirect investment in residential lettings as assets would carry a de facto tax penalty in comparison with directly owned commercial property assets.

When the 'Bacon measures' started to have an impact on the PRS and slowed construction activity, the construction industry started to put pressure on the government to further stimulate the market. This is one reason why stamp duty was reformed and interest deductibility re-introduced. The effect of the December 2001 budget measures were still to fully feed through into the market at the time of this research.

It should be noted that tax allowances, including S23 allowances and interest deductibility, can only be offset against rental income and not other income. Hence 'negative gearing' is not possible in Ireland, as it is (and has been) in some other countries (Crook, 2000). It should also be noted that the capital gains tax regime allowed roll-over relief to enable gains to be re-invested in PRS stock up to 2003.

“The Irish government has used fiscal measures in an attempt to control the supply side of the PRS.”

3: Rates of Return in the PRS

3.1 Introduction: Measuring returns

This section of the report examines the rates of return in the Irish PRS and makes comparisons with evidence of returns from other property investments in both Ireland and throughout Europe. The European comparisons are also used, where available, to determine residential property returns in countries where there is substantial institutional investment in this property sector. The lack of data on the residential market in Ireland and, in particular, on total returns from residential investment has made this task problematic but published data from a variety of sources have been used to estimate the economic potential of institutional investment.

A variety of measures have been used to calculate investment returns in the PRS (Crook et al, 2002). These include gross and net income returns and total returns. Income returns measure the annual percentage returns from rents on open market vacant possession capital values. Gross returns use the total rental income. Net returns deduct management, maintenance, and other running costs (including voids and arrears) from gross rents, but do not include interest payments in these deductions. It is rare to find rates calculated from returns on equity, where interest payments are also deducted from gross rents and returns expressed as a percentage of the equity. Expenditure on improvements (as distinct from expenditure on repairs and maintenance) are treated as capital items and added to the vacant possession capital value (and depreciated as annual costs on the income and expenditure account). Total returns add annual capital growth to net income returns. Capital growth is usually measured in nominal terms when year-on-year returns are being estimated. Annual average real capital growth is used when returns over the longer terms are being estimated.

3.2 Residential Property, Institutional Property Portfolios, and Investment Returns in Europe

Table 1 below shows the balance of property assets in institutional portfolios. Sweden, France and the Netherlands have significant institutional holdings of residential property. The UK has also seen significant growth in recent years from the low base of 2000. Ireland is unique in having no recorded residential investment in institutional portfolios.

Table 1 The balance of property portfolios in Europe

	Offices	Retail	Residential	Industrial	Other
Sweden	70	6	18	2	4
Ireland	60	26	0	14	0
France	47	11	32	0	10
UK	35	50	1	11	3
Netherlands	25	20	50	2	3

Source: Key (2001)

Returns on residential property in those countries with a significant element in institutional portfolios are shown in table 2.

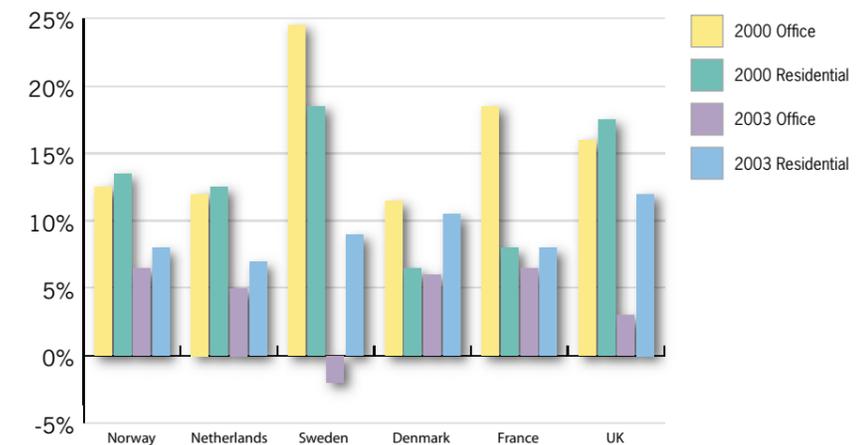
Table 2. Total Returns (%) for the Residential Property Sector

	2001	2002	2003
Norway	12.1	14.6	8.1
Netherlands	12.1	8.3	7.1
Spain	11.6	15.4	8
Sweden	11.4	10.6	9.6
Denmark	15.7	14.3	10.9
France	6.6	7.3	8.6
Portugal	21.1	10.9	10.7
UK	17.1	20.1	11.5

IPD (2004) Various Property Quarterly Bulletins (IPD Website)

Residential total returns in the Denmark, Portugal and the UK were in double figures in all three years. Although returns were much lower in France the returns are still comparable with those from office investments (See Figure 2 - below). Returns were consistent with a narrow range of between 7.1% and 11.5% in 2003. Total returns for residential investment in Ireland are not available due to the absence of residential property in institutional portfolios. Despite a wide-ranging search for sources of data relating to residential returns, none could be found. Figure 2 shows that residential total returns outperformed office returns in all countries examined for 2003.

Figure 2: Residential and Office Total Returns in Selected European Countries



Source: IPD (2004)

House price growth in Ireland is among the highest in Europe behind only UK in 2002 (RICS 2004). Therefore the capital growth element of total returns is significant. Figure 2 shows that residential returns were higher than office returns for 2003 and comparable in 2000. If we make an assumption that residential total returns, with the high element of capital growth through rising house prices, are comparable to office returns in Ireland then an examination of office returns will provide an indication of the potential of residential investment. Table 3 does just that. Total returns were the highest in Europe in 1999, 2000 and 2003 and ten year returns from direct property were also above 16% and indirect returns were over 23% illustrating the investment potential of property (Table 4). The assumption of comparable residential and office returns in Ireland indicates total return is not a barrier to institutional investment.

Table 3. Direct Total Returns for the Office Sector

	Total Return 1999	Total Return 2000	Total Return 2001	Total Return 2002	Total Return 2003
Ireland	31.2	28.7	8.2	2.3	2.7
Portugal	-	10.9	14.0	13.5	9.5
UK	14.7	10.5	6.7	9.7	10.9
Denmark	-	9.6	9.5	10.2	7.4
Netherlands	15.8	16.1	11.4	8.8	7.1
Canada	10.6	12.1	9.3	8.9	8.2
France	13.7	14.2	9.8	8.6	8.0
Spain	-	-	9.0	8.3	7.9
Norway	-	12.7	11.1	6.8	7.8
Germany	5.0	5.6	5.9	4.2	4.2
Sweden	17.6	22.1	4.8	2.4	0.9
Switzerland	-	-	-	5.7	5.2

IPD (2004)

“The assumption of comparable residential and office returns in Ireland indicates total return is not a barrier to institutional investment.”

Table 4. Ten year Investment Performance

	France	Germany	Ireland	Netherlands	Sweden	UK
GDP Growth	1.8	1.9	6.9	2.8	1.7	2.2
Inflation	1.7	2.3	2.6	2.4	2.3	3.2
Direct Property	5.3	3.8	16.8	10.2	2.5	9.2
Equities	17	12.3	19.7	12.4	29.5	14.3
Indirect Property	5.7	-1.1	23	5.6	-2.1	9.4
Bonds	9.3	8.3	9.5	8.7	1.8	11.3

IPD (2004)

3.3 Residential Investment in London

Data have been published on the London residential investment market (Cluttons 2001-04) which provide some evidence as to the potential performance of residential investment, particularly in Dublin. London residential property outperformed UK commercial property, UK gilts and UK equities in 2000. For the five years up to 2001 total returns averaged 19%. For the period 1993-2000 residential investments in London outperformed UK commercial property, UK Gilts, UK equities with only London offices showing greater performance (Cluttons 2001). However, the market has changed over the last 3 years. The first quarter of 2004 was the first since September 2001 in which rents did not fall. Rents in London sub markets have fallen by up to 7% in the last year, 3.3% on average (Cluttons 2004). This is partly due to an expansion in the buy-to-let market in London increasing the supply of rental property.

The Cluttons' reports state that residential property investment has a diversification characteristic. Residential total returns in London displayed almost no relationship with either UK equity or UK Gilt returns. Residential property also had a lower return correlation with UK equities than commercial property. This suggests that there is a case for residential property to be included as part of an investment portfolio.

Conventionally, residential lettings are seen as higher risk with lower liquidity than other financial and property assets. However, recent years have seen a reduction in the risk on residential lettings in the UK as the market became more knowledgeable of the sector and learnt to better manage market and specific risk. Recent years have also seen a reduction in illiquidity since rent deregulation in 1988 in the UK which has increased the certainty of landlords gaining vacant possession of property. Investment timing is important, especially in relation to capital growth cycles. Moreover, other evidence suggests that most potential investors examine the manner in which assets contribute to their whole portfolio, rather than examining returns from each asset class in isolation on a year by year basis. In particular, residential lettings are thought to provide additional diversification potential, since returns move in a different cycle from other property returns (Crook and Kemp, 1999). This all suggests that there is a case for considering residential lettings as part of a balanced property portfolio.

3.4 Initial Yields in the Residential Market Ireland

A potential barrier to institutional investment is the initial yield on residential investment. This is a crude indicator of investment potential measuring income available in the first year of the investment as a percentage of the capital outlay. Institutions will use this measure to assess investment potential. Institutions have target or hurdle rates of return when assessing investment worth. If these measures are not achieved the investment will not occur. It is therefore vital to examine the initial yields or income returns available from the PRS.

Data was collected from various sources on prevailing rents in the Dublin market as well as house prices. An additional source of house prices was obtained from the Department of Environment & Local Government. By comparing rent with the purchase price of a property it is possible to calculate the initial gross income return. Gross income returns in Dublin were calculated to be between 5% and 7% in 2002. These yields were confirmed by research carried out and published in the Gunne Report (2002) on the residential lettings market. Yields have fallen since 2002 with prices rising faster than rents. The 2004 Gunne report (Gunne 2004) estimated Dublin gross yields as falling from an average of 4.6% in 2002 to 3.9% in 2003 although their recent rental bulletin (Gunne 2003) states average rental yields are 4.5% in North Dublin up to 4.8% in west Dublin. Average rents for a two bedroom property were said to be €1,400 putting the market price of such a property at around €350,000. We repeated our simple exercise of 2002 and calculated gross yields on two bedroom properties to be between 4 and 6%.

The report also commented that Investors purchased approximately 15% of all second-hand residential property and 25% of all new home developments in Dublin in 2003.

There is however no information about the costs of management and maintenance. Survey evidence from England shows that these costs take up an average of 27% of gross rent, the exact proportions depending in part upon whether the landlord is an individual or a property company (Crook et al, 2002). Allowing for these costs to take up a third of rents suggests that net income returns in Dublin would be under 3% in 2004. This suggests that initial income returns are low, but that total returns based on the high nominal increases indicated in Table 4 are likely to have been very substantial in recent years.

IPD provides data on yields income returns for selected European countries which can be used as a basic comparison with net and gross yields from the Dublin residential market. In the UK the average gross yield on residential property in 2003 was 6.1%, the net yield was 3.8%. This means that income receivable after costs is now below the Bank of England's base rate. Both gross and net yields have fallen over the three-year period, as a result of rising capital values and stable or falling gross and net income levels (IPD 2004). The gross yields are significantly higher than average yields in the Dublin market. At the end of 2003, the net yield on properties in Central and Inner London stood at 3.5%, and in Northern England and Scotland it was 4%. In France 2003 income yields for all property was 6.4%. The Aedex / IPD Social Housing Property databank index for the Netherlands showed income returns of 2.9% and the Imométrica/IPD Portuguese property Index shows income returns for residential property at just under 8%.

This evidence suggests that net yields in Ireland are not very attractive to investors and are unlikely to attract institutions seeking income returns. Total returns are good but due almost entirely to capital growth.

3.5 Institutions and available residential returns

The evidence available on prevailing rents and prices suggest residential investment provides a low rate of net income return. As initial yields are a signal to potential investors, these low yields may deter institutional investment (see next chapter). Further data are necessary on residential gross and net yields throughout Europe (and are available from IPD) to make further comparisons. This would establish whether initial yields in those countries with high levels of institutional investment are significantly higher than those in the UK and Ireland and whether these yields are the key to stimulating investment in the private rented residential sector.

This stage of the research has shown that there is a plausible case for investment in residential property by institutions, based on available evidence of total returns and particularly the capital growth element. However, the lack of good data and long run evidence about both income and total returns for residential

“Recent years have seen a reduction in the risk on residential lettings in the UK as the market became more knowledgeable of the sector.”

property make it difficult to prove a watertight case for residential investment, but based upon figures for other European countries, residential returns are likely to be similar to office returns in Ireland. Office returns in Ireland have outperformed all other European property markets in the last 10 years and have shown total returns of over 20% from 1998-2003.

However, the lack of past performance measures and current performance benchmarks for residential property make investment in commercial property more prudent from the institutions' point of view. This may of itself be inimical to increasing supply by institutional investors, since it increases uncertainty for landlords and those who finance them, especially for those thinking of entering or funding the sector for the first time. There are cultural/historical reasons in addition to the lack of performance measures that have prevented institutions from investing in residential property even though there is plausible evidence that the economic case is good in terms of total return (see chapter 4).

There is not one 'hurdle' rate of return needed to attract investment into the residential market, rather it is likely that there will be several. Specifically four can be identified:

- Returns that enable existing investors to stay in the market, with or without expanding their existing holdings;
- Returns that encourage existing landlords to enlarge their portfolio, adding additional properties either at the margin or by a substantial amount;
- Returns that allow existing (as well as new) landlords to bring existing sub-standard property up to socially desirable standards, acknowledging that in some sub-markets with poor quality housing there may be considerable market constraints upon landlords being able to charge the level of rents to give the returns needed;
- Returns that encourage new landlords to enter the market, especially corporate landlords with institutional funding.

It can be suggested that returns to encourage new landlords will be higher than returns that enable existing landlords to expand their portfolio and/or to improve their existing stock. This is because of the novelty premium that will be needed to entice those unfamiliar with the market and who will be uncertain of the rents, costs, and risks of engaging in the newly emerging deregulated sector. It can also be suggested that returns required by companies and institutions (both existing and new landlords) will be higher, *ceteris paribus*, than for individual landlords because the latter tend not to charge their own time to the costs of managing and maintaining their properties and nor do they incur the normal running costs of a limited company or partnership (such as the costs of auditing accounts and submitting company reports).

Finally it should be stressed that even the limited evidence on returns cannot be relied upon as a guide to the returns that institutional investors might earn. This is for two reasons. First, rents are probably set by landlords to cover their costs, rather than give a benchmark return on capital employed. Second, current landlords' portfolios are too small to allow them to achieve economies of scale in management and maintenance costs or to substantially spread risk through market diversification. This suggests that income (net rental) returns are probably lower today than they would be if the market generated more large scale and commercially oriented landlords, explicitly setting rents that the market would bear, achieving scale economies, and able to gear up investments by borrowing in the capital markets. Hence a combination of higher rents and lower costs (including interest charges) would yield greater rental returns.

4: Institutional Investment in the PRS: The Current Position

4.1 Introduction

This section discusses the current involvement of institutions in the private rented sector in Ireland. First is an examination of the extent of institutional involvement in the PRS. This is followed by an investigation of the barriers to further investment in the sector. The tax position of institutions with regard to investment in residential property is also examined. The section is completed by a discussion of the future of institutional investment in the private rented sector if the current position remains unchanged. The material in this chapter is drawn from interviews with key informants and an examination of the limited relevant literature.

4.2 Benefits of institutional involvement in the PRS

Many of the key informants argued that there are a number of reasons why the involvement of financial institutions in the PRS would benefit the sector, particularly tenants. The management of properties by institutions would be very different from the property management approaches adopted by most individual landlords. Professional management would ensure that all landlord and tenant legislation was adhered to, resulting in the better treatment of tenants. This may feed through into a general increase in the standard of landlords throughout the sector. Institutions would also be looking to maximise returns and active property management is one method of achieving this. Long term investment and active property management could prolong the life of much PRS stock. The involvement of financial institutions in the PRS may raise the perception of landlords in the public's eyes by increasing professionalism and security for tenants.

4.3 The extent of current institutional involvement in the PRS

There is little, if any, direct investment from Institutions in the PRS in Ireland. During our research we spoke to numerous institutions, both Irish and overseas institutions, to examine the extent of investment in the PRS. None of these institutions invested directly in residential rented property. Indirect involvement through mortgage and other debt funding was, however, common.

Ireland has no residential property in institutional portfolios covered by Investment Property Databank (IPD). IPD collect and analyse investment data from the majority of institutions operating in Europe. They provide data not only on portfolio structures but also on rates of return for all property asset classes. Their return benchmarks are used by leading fund managers and are a vital tool in performance tracking. IPD's coverage of European property markets has increased substantially in the last 10 years.

Table 1 above (chapter 3) shows the approximate structures of institutional property portfolios in selected European countries. Ireland is the only country in the sample with no investment in residential property. Nearly a third of portfolios are made up of residential property in France and the figure is 50% in the Netherlands. This is reflected in the relatively low percentage of owner occupiers in these two countries when compared to Ireland (54% in France and the Netherlands compared to 79% in Ireland.)

4.4 Barriers to Institutional Investment

Given the evidence presented above and in the previous chapter, the key question is why institutional investment is so low in Ireland when compared to other European countries? Our research has identified a number of significant barriers to investment and these are discussed below.

Reputation: The Mespil Estate case

All the interviewees questioned during our research agreed that there was little, if any, institutional investment in the PRS (although institutions have considerable holdings of commercial property) and all

“There is little, if any, direct investment from Institutions in the PRS in Ireland.”

pointed towards the same example as the main reason for this. It surrounds the adverse publicity received by Irish Life over the Mespil Estate properties. Irish Life sold Mespil Estate. The existing tenants had been there almost 20 years and were soon able to utilise regulations entitling them to 35 year extensions on their lease. This would have implications for the investment value of the property. The new owners of the property removed the sitting tenants and this reflected badly on Irish Life as many believed it was the institution that had taken the action against the tenants. This fear of adverse publicity resulting from dealings with individual tenancies is one of the main reasons preventing institutions from investing in residential property.

The new Residential Tenancies Act 2004 (see below) will abolish the right of new applicants to a long occupation equity lease in 5 years time thus removing the circumstances under which the Mespil case arose.

Management Issues

Management issues were the second reason cited for the reluctance of institutions to invest in the PRS. The management costs of investment in many individual properties, some with more than one tenancy, are high. Institutions would have to employ property management companies to manage individual properties or groups of properties within the overall investment portfolio. By contrast, the management costs associated with a large commercial property are a fraction of the purchase price. High management costs will impact on the overall return generated by the portfolio. This leads to the related issue of lot size. The larger lot sizes of commercial property minimise management costs as a percentage of overall costs as well as providing many institutions with flagship investments. UK institutions are moving towards investment in larger and larger commercial properties to maximise returns by minimising investment costs. Unless a large portfolio of residential properties was available for purchase, the costs of individual transactions and individual property management would outweigh the potential returns. The establishment of specialist management companies within, or contracted by, institutions may reduce these costs.

Taxation

There are no taxation barriers to institutional investment nor are there any specific incentives. Institutions will pay tax on residential investments at the same rates as commercial property investment (and pension funds pay no tax on directly owned property) and with commercial property offering greater returns and more favourable investment characteristics, institutions are likely to choose this investment asset for their portfolio. It was stated that the government was unlikely to alter the current tax position to encourage residential investment. Moreover, interviewees also stressed that investments would be judged on their commercial case alone and that investments where the yield was dependent on tax breaks would be too risky. Investments where returns are ‘uncluttered’ by tax breaks are favoured. In general it was argued that tax incentives had been ‘overdone’, although there were good reasons for introducing them at the time.

Performance Benchmarks

Institutions use benchmarks in the form of indices developed by organisations such as IPD to track the performance of their various investment portfolios. IPD produce benchmarks for all property types which provide measures of capital growth, income growth, rental returns and total returns. These are based on the overall performance of an asset in a specific property market (city, region or country for example). Institutions then use these indices to compare the performance of their portfolios. They are able to identify whether a portfolio is under or over performing and can adjust the structure of the portfolio accordingly. Without these indices, institutions would not be able to assess the performance of their funds against competitors and the market average. Institutions are risk averse in nature and use the indices to assess the risk structure of their portfolio when compared to the performance of the market as a whole. For example,

an underperforming asset such as office property in a particular city can be substituted for a retail property performing above the market benchmark.

IPD collect and publish data on residential markets throughout Europe. Ireland is an exception and no data are available. This means that an institution wishing to invest in residential property in Ireland have no means by which to assess the performance of its particular portfolio of properties against the market as a whole. This increases investment risk. If institutions are unable to easily identify underperforming assets then they cannot make the necessary adjustments to maintain levels of total return in line with competitors.

Rates of Return from Residential Property

During the research rates of return were identified as a barrier to investment. Overseas institutions with a history of residential investment in markets outside Ireland are looking for net income returns around the 10-12% level, whereas residential income rates of returns in Ireland were thought to be no greater than 3-5% compared to 4-7% in the UK. The level of returns desired by many institutions are thought only to be available from niche markets in Ireland.

As chapter 3 discussed, there have been good returns from the PRS in the last 3-4 years, but institutions are looking for long term performance and some interviewees argued that the long term yield on residential property does not warrant investment at this time. With gross yields between 4 and 6% in Dublin (higher than the returns expected by some interviewees) the returns fall short of those required. Traditionally returns on commercial property are higher and there have been cases where development land has switched from residential to commercial use. However, the evidence displayed in chapter 3 described residential returns as higher than office returns in many European countries. Institutions should review the evidence and reassess the returns based case for investment in residential property. However, there is the added problem of uncertainty and returns. With past government intervention in the Irish residential market there is no certainty for corporate investors adding to the risk of the investment and raising the required return. The lack of return benchmarks such as those produced by IPD for other countries adds to the risk and consequently the required level of return.

4.5 Summary

There is little, if any, institutional investment in the PRS in Ireland. The barriers described above mean there is unlikely to be a change in investment levels unless new measures are introduced to encourage investment. From our interviews and a seminar run on behalf of Threshold with representatives of the banking sector, institutions have no immediate plans to invest in the PRS. Indeed, a report by an 18-member Commission on the Private Rented Residential Sector submitted to the Minister for State with responsibility for Housing in July 2000 concluded that investment by the corporate or institutional sectors in residential property would remain at a low level and that for the foreseeable future the sector would be almost totally reliant on the small private investor. However, there are measures that could be implemented that would encourage institutional investment and these are described in the next chapter. Two of these measures have already been introduced, Part V of the Planning and Development Act (as amended in 2002) and the Residential Tenancies Act 2004.

“The lack of return benchmarks such as those produced by IPD for other countries adds to the risk and consequently the required level of return.”

5: WHAT CAN BE DONE TO INCREASE INSTITUTIONAL INVESTMENT IN THE PRS?

5.1 Introduction

The previous chapter discussed the current level of institutional investment in the PRS and the barriers preventing investment. This chapter examines measures that could be implemented to overcome these barriers and increase the level of institutional investment. It examines five measures that may have an impact:

- Special Purpose Investment Vehicles similar to the proposed Property Investment Fund in the UK.
- Private Public Partnerships.
- Increased data availability and the introduction of performance benchmarks in the PRS.
- New tenancies legislation introduced by the Irish government.
- Part V of the Planning and Development Act 2002 and UK style Housing Associations.

This chapter describes the initiatives and how they could impact on institutional investment.

5.2 Special Purpose Investment Vehicles: Property Investment Funds (PIF)

A report by Kate Barker of the UK HM Treasury (2004) tackled the issue of housing supply in the UK. Barker made a number of recommendations that would redress the balance between demand and supply in the UK housing market. One of her recommendations was the introduction of a Special Purpose Vehicle for investment in all types of property. Barker argued that the advantages of a SPV such as a Real Estate Investment Trusts (which have been important in the US for many years) were:

- Such vehicles could commission new build. This would directly increase the supply of new properties.
- Such vehicles have clear incentives, as well as the financial strength, to maintain their properties. This could lead to higher quality and a more professional private rental market, improving its attractiveness, and thereby helping to create a better balance of housing tenures.
- Long-term investment may promote greater stability in the market, as such vehicles would have greater access to equity finance, are therefore typically less reliant on debt financing and so less vulnerable to interest rate changes as well as being subject to greater market scrutiny.
- There is potential for institutional investment to play a greater role in managing subsidised housing.

These advantages reflect those outlined by Threshold regarding the benefits of institutional investment in the PRS in Ireland. Barker's formal recommendation to the UK government was that "Government should deliver its proposals to promote greater interaction between institutional investors and the residential property market, through the introduction of tax transparent property investment vehicles."

Indirect investment through a SPV was considered to offer potential for increased investment by many of those who participated in this research. Such intermediary vehicles would avoid direct contact between institutions and tenants thereby avoiding any potentially damaging publicity. How institutional investment in such SPV in Ireland would be taxed is currently unclear. Bacon recommended the use of such intermediary vehicles to the government and asked them to pursue the Housing Investment Trust (HIT) initiative in the UK (see Crook & Kemp, 2002), but the recommendation was not implemented. In principle, such trusts including the proposed PIF, offer the prospect of tax transparency for non tax paying funds wanting to invest indirectly.

The UK government announced in its 2003 pre-budget report that it would look at developing legislation to introduce a Property Investment Fund (PIF) which would permit indirect investment in all property types. HM Treasury published a consultation document on the details of PIF earlier this year. It discusses the main issues surrounding a PIF. This report is of direct relevance to the Irish market. The measures could be introduced in the Irish property market to promote indirect investment by institutions. The relevant issues discussed in the report are summarised below.

Property Investment Funds

The report by the UK HM Treasury (2004) set out the aims of PIF: "the Government has concluded that reform to the tax treatment of property investment would improve liquidity, transparency and scrutiny, provide access to property for long-term savings, and could expand the private rented sector."

In the UK the investment market for property accounts for an estimated £250 billion, almost half of the commercial stock of property. This total stock is held by a range of bodies, including large financial institutions, property companies (either listed on the Stock Exchange or in the private market), limited partnerships and private investors, based either in the UK or overseas. Since the 1980s large institutions such as pension funds and insurance companies have reduced the share of property held in their portfolio of assets, opting instead to invest more of their funds in equities. The government wants to address this issue by providing a convenient means of investing in property without the associated management and legal costs.

The report outlines concerns that barriers in the tax system may be contributing to distortions in the market for property investment resulting in:

- lack of choice for small investors – who tend to access property in higher risk ways, such as buy-to-let investments or direct ownership, and therefore cannot diversify their portfolio to reduce risk;
- poor liquidity – which is a reflection of the nature of property itself as an asset. The commercial property market is dominated by large investors and pricing and investment decisions are largely determined by individual transactions among a small number of players;
- potential for more efficient use of property – a high proportion of commercial property in the UK is owner-occupied, and this tends to be used less intensively than property in the investment market. More indirect investment may allow increased efficiency through economies of scale;
- high levels of debt financing – which increase the sector's sensitivity to interest rate changes, coupled with lower transparency and scrutiny in the private sector, may lead to instability in the wider economy;
- tax distortions – as investors are taxed differently depending on how they invest in property, it is not easy to compare performance of different investment choices. This may result in investors undertaking more risky, less suitable investments than if it were possible to make a simple and direct comparison; and
- variable standards of provision in the private rented sector – with the lowest quality housing stock and management at the bottom end of the market. Improvements and expansion to this sector could enhance efficiency and flexibility in the housing market.

Institutional investment in the UK residential sector is low and over 70 per cent of the private rented stock is run by landlords managing only a few properties. There is significant variation in the quality of both management and property with the bottom end of the market having some of the lowest quality housing stock.

The US Real Estate Investment Trust (REIT) market provides an example of the success of more institutional investment breaking into the residential market. For the UK and Ireland this could allow more efficient management, greater renewal and preservation of property, and a more liquid supply of housing. This in turn should help to promote greater labour market mobility for the UK economy and address problems of the provision of affordable housing, including for key workers in areas of high house prices

PIF Objectives

Any new PIF should:

- improve the quality and quantity of finance for investment in both commercial and residential property in a manner that promotes economic stability and market flexibility and helps to increase the supply of property;
- expand access to a wider range of savings products on a stable and well regulated basis, and therefore promote long-term savings for individual investors;
- protect all taxpayers by ensuring that a fair level of taxation continues to be paid by the property sector, and reduce opportunities for tax avoidance;

"The US Real Estate Investment Trust (REIT) market provides an example of the success of more institutional investment breaking into the residential market."

- support structural change in property markets to reduce the costs and improve the quality and flexibility of commercial property to business users, and to improve efficiency, affordability and professionalism in the private rented sector for residential tenants; and
- promote long-term investment in property, to maintain over time a high quality stock of property and encourage the more efficient management of property.

Rental Housing

The social housing and private rented sectors together account for around 30% of the UK housing market – the remainder being in the owner-occupied sector. PIFs have the potential to increase corporate and institutional investment resulting in higher standards in the rented sectors, and provide an alternative to the highly geared buy-to-let market. The UK government, the report states, is also keen for a PIF to stimulate greater development activity in the residential market providing a vehicle into which new properties can be converted and managed more efficiently. This has direct implications for the PRS in Ireland with a PIF structured in the way envisaged in the report addressing many of the concerns expressed by Threshold.

Property Management

There is a debate over the extent to which a PIF should have day-to-day responsibility for managing the properties owned by the fund. In some countries it is a requirement that property assets are managed internally, while in other countries the market is free to choose.

In most countries where equivalent property investment vehicles exist, particularly the US and Dutch markets, internally managed structures have historically been more popular. The Australian model allows for both types of management, although investor sentiment is now also tending towards internal management after initially preferring external management.

Detailed tax measures

The taxation of the fund is crucial in attracting institutional investors. A key feature that would accompany any relaxation of the corporation tax rules within a PIF would be a requirement to distribute a high level of income to investors. This would play a key role in determining the trading value of units or shares in a PIF. Essentially the value would be determined by reference to the income stream as much as by the balance sheet value of the underlying capital assets.

The assumption is that the PIF would pay no tax on rental income it received from its property management activity, and should therefore make available all of its rental income to distribute to investors. One way of achieving this would be to treat any income distributions made to investors by the PIF as a deductible expense when calculating taxable profits subject to corporation tax (as is the case for interest distributions of unit trusts). Any rental income not distributed would then be taxed as income from property for the PIF. This could either be at a standard rate, or, for example, at some special rate applicable to the PIF, similar to the 20 per cent rate applied to authorised unit trust income in the UK.

An alternative would be for some or all of the rental income itself to be specifically exempt from tax. PIF would be exempt from tax on any capital gains it realises, but be prevented from distributing capital. Tax in relation to the PIF's realised gains would then not be chargeable until the investor's units or shares are sold. This would have the effect of deferring taxation to a time of the investor's choice.

A possible approach to allow greater certainty of revenue receipts would be to require PIFs to distribute all, or most of their realised capital gains, as part of the general distributions they would be required to make. For example, at present when companies distribute profits derived from capital gains (net of any corporation tax due), the amounts distributed are treated as income in the hands of the investor (including corporate investors).

The tax issue is one of many details yet to be addressed by the UK government. It is likely that the Irish government would wish to structure any PIF introduced in Ireland to suit their own taxation strategies.

Taxation of Non UK Residents

At present, non-UK resident investors are exempt from capital gains on the disposal of UK property. To continue such an exemption for non-resident investors in a PIF would depend partly on decisions made on distribution rules for PIFs. If no distributions arising from capital were permitted, the exemption would, in effect, apply equally to those investing indirectly via PIFs as it does to direct UK investors. Any capital gains made by the PIF would be reflected in increased share value and any gains made by non-resident investors on the sale of the shares would, as the law currently stands, fall outside the charge to UK tax.

If, however, there were a requirement to distribute realised capital gains, these would need to be characterised as income from property. Otherwise, the present capital gains exemption for non-residents would require what could be quite complex sourcing rules to establish the factual composition of each distribution to distinguish between distributions arising from capital gains and distributions arising from income. Tax treatment of distributions to other types of institutional investor would need to be considered once a clearer idea of the structure of the PIF itself has been developed. This would include charities, pension funds and life companies.

If a UK PIF was introduced with no Irish equivalent it is possible that equity that would otherwise have been invested in Ireland would be directed towards it. The Irish government would need to introduce their own measures to prevent this and attract their own overseas investors.

5.3 Private Public Partnerships

Public Private Partnerships have been promoted as a means of securing institutional investment in property. There are initiatives developing around PPP and the potential for PPP schemes to provide accommodation for SWA tenants. SWA tenants would provide a guaranteed income offering some certainty to institutions.

Participants in this research stated that financial institutions would not want, by and large, to fund investors relying on rental income that offers any significant risk of non-payment or of property damage. Recognising therefore that rents at the bottom end would not give an adequate income return on new construction costs, some interviewees argued that Public Private Partnerships (PPP) in some format may have a part to play in funding this additional accommodation and hence the private sector could be encouraged to invest with a guaranteed income from SWA tenants.

The Irish Government's Rental Assistance Planning Group has proposed the involvement of PPP as a means of developing a supply-based scheme of rental assistance (Department of the Environment & Local Government, 2002). There is therefore a need to examine the potential for institutional involvement in housing PPP projects. New rental housing assistance measures have recently been announced by the government whereby local authorities will assume the responsibility for meeting the long term housing needs of around 19,000 households reliant on rent supplements for 18 months or longer. The new arrangements will extend the social housing role of local authorities through direct engagement with the private rented sector. Long term rent supplement recipients will now be catered for through accommodation based approaches rather than through direct rent supplement payments. The type of accommodation provided will include specifically built premises and new developments under PPPs which could be financed, developed and operated on a long term basis exclusively for households designated by local authorities (Department of Social and Family Affairs Press Release July 2004).

As part of the Government's commitment to developing the Public Private Partnership (PPP) approach as an important element in delivering infrastructure investment under the National Development Plan 2000-2006 (NDP), local authorities have been asked to consider the potential for using PPP arrangements in a range of housing areas, including social and affordable housing provision, the management of housing estates, the provision of rental accommodation, and the carrying out of remedial works and regeneration schemes. It is hoped to advance a small number of suitable pilot PPP projects in housing. Apart from some "design-build" contracts entered into with the private sector for the delivery of social and affordable housing in

“If a UK PIF was introduced with no Irish equivalent it is possible that equity that would otherwise have been invested in Ireland would be directed towards it.”

mixed tenure developments, it is envisaged that a pilot programme to examine the potential for providing long-term public-private rented accommodation through arrangements between local authorities and the private sector, will be initiated in the near future.

The Local Authority PPP Grant Fund, which provides “seed” funding towards the costs of the start-up phase of projects, has also approved funding for a number of feasibility studies to examine the PPP potential in the areas of housing estate management, the delivery of social and affordable housing and the mixed-tenure development of suitable local authority lands.

The pilot projects, if successful, will provide evidence of the potential of PPP in the housing sector and provide a stimulus for institutional involvement. Until such pilot projects have been completed and their potential publicised it is difficult to assess the impact of PPP in encouraging institutional investment in the PRS.

Additional areas of institutional involvement through PPP include the provision of student accommodation on campus through Section 50 provisions. The educational establishment would provide the land and the institution the funding.

5.4 Increased Data Availability and Performance Benchmarks

As discussed in chapter 4, the lack of available data on residential investment returns coupled with the absence of investment performance benchmarks, such as those produced by SCS/IPD for the commercial property market in Ireland, increase the risk of investment. Without benchmarks of overall market performance it is difficult for institutions to track the performance of their funds to identify over or under performance and allow appropriate portfolio restructuring. For example, with commercial property it is possible to identify which market sector is performing well and subsequently transfer investment between sectors. Without data on general performance in each market sector this cannot be achieved effectively.

Organisations such as Sherry Fitzgerald and Gunne Research produce market bulletins detailing general trends in market performance and these bulletins contain data on passing rents and achievable yields. There is no reason why such data on the PRS could not be pooled to provide a service equivalent to those provided by IPD on the commercial sector. Rent and yield indices published quarterly would not only inform institutions of the potential returns available from the sector but also permit limited performance benchmarks. The greatest problem is that IPD collect data from institutions active in the commercial property market and produce results from these data. With the lack of institutional investment in the residential sector this is not possible.

Data in the PRS would have to be collected from individual landlords which is costly and then compiled to produce appropriate information. Data on passing rents, management costs and net yields, for example, and basic indices produced for regions, cities and sub-markets for the various property classification; flats, terraced houses etc. This would require a considerable input of resources from any organisation attempting to do this on a sufficiently large scale. However, it would be invaluable not only for individual investors but also for institutions who would be able to identify the best performing locations and property types.

The registration of new tenancies under the Residential Tenancies Act 2004 may have a role to play (see below).

5.5 New Government Measures in the PRS

There are two key pieces of legislation recently introduced by the Irish Government which will have an impact on the PRS and potentially on institutional investment in the sector. First is Part V of the Planning and Development (Amendment) Act 2002 (and subsequent amendments) and second is the new Residential Tenancies Act 2004. These are discussed in turn.

Part V Planning and Development Act 2002 and UK style Housing Associations

Under Section 96(2) of Part V of the Planning and Development Act (2000, amended 2002) up to 20% of a development in the form of land, completed units or fully or partially serviced sites must be provided for

social and affordable housing. The local council determines the actual percentage to be transferred and this will vary depending upon their housing strategy. Under amendments introduced in 2002 the local authority may receive ownership of other land or new units on other land, payment of a cash sum or a combination of the above. Different councils have different targets and policies.

The developer’s contribution is split between social and affordable housing. The split is set by the local authority. Social housing is commonly defined as social rented units whereas affordable housing is housing made available to purchase at an affordable price. This price is calculated by taking the current agricultural land price, the cost of construction and an agreed level of profit for the builder. On average there is likely to be a saving of €50,000 but it can be far larger.

Part V of the Act has the potential to increase the supply of housing to those on low incomes. To date few units have been provided through the Act and the mechanisms of funding and management of the social units is unclear. There is potential for UK style Housing Associations to become involved. Currently Irish Housing Associations operate on a very small scale delivering very local need (around 10 units). A few Housing Associations such as the Iveagh Trust and Cluid operate on a larger scale. Irish Housing Associations account for around 12,500 social housing units, about 11% of the total social housing stock although their share of social housing completions is growing. With an increase in the supply of social housing there is potential for the further expansion of the Housing Association sector in Ireland and this has implications for institutional involvement in residential property.

Part V of the Planning and Development Act has the potential to increase the supply of social and affordable housing with up to 20% of a development site, alternative serviced sites, or cash equivalent to be transferred to a local authority. This is similar to the Section 106 policy operating in England where a proportion of a development site is set aside for the development of affordable housing (note the definition of affordable housing in the UK includes social housing as well as alternative tenures such as shared ownership, key worker housing and low cost home ownership, the nearest equivalent to the affordable definition used in Ireland).

In the UK Registered Social Landlords, the majority of which are UK Housing Associations, are involved early in the planning system and negotiate agreements with the local authority and developers. These negotiations involve the either the transfer of land to a Housing Association who then develop the affordable units or the transfer of completed units. In both cases the Housing Association will fund the purchase of the units, often at a discount as part of the agreement, let and manage the units. This policy secured over 12,000 completed units in 2002/03, over 40% of all affordable units completed in that year (Crook, Rowley et al 2002).

Part V in Ireland could operate in a similar way to Section 106 in the UK however, Irish Housing Associations do not have the capacity to finance, deliver and manage units on such a scale. In Ireland, Housing Associations are smaller than their UK counterparts and their financial structure does not appear to generate sufficient income to cover all costs including maintenance. This is especially important in the case of projects being developed under Part V since management costs tend to be high when social mixing is involved.

There is scope for institutional involvement in the funding of UK style Housing Associations in Ireland for the delivery of social housing through the Part V policy. The UK system has evolved over the last 25 years. Housing Associations fund development through a mixture of private (debt) and public (fixed grants) funds. Private funds are secured on the rental income of social housing and public grants are based on development costs and are now funded from central government through the Housing Corporation. Also housing benefit levels are designed to cover costs with payment direct to landlords a feature of the system at least until recently. Many Housing Associations have built up considerable equity over the last 20 years and are in a position to secure private funds at relatively favourable rates. This was not the case 25 years ago when this sector was relatively small and immature. In order to ‘grow’ the government had to shoulder much more of the risk, had put large per property grants ‘up front’ and directly provided small amounts of debt to fund the residual.

“There is scope for institutional involvement in the funding of UK style Housing Associations in Ireland for the delivery of social housing through the Part V policy.”

During a seminar run by Threshold with the banking sector there was considerable discussion of the potential of UK style Housing Associations to become involved in the Irish market taking advantage of the supply of social housing through Part V of the Planning and Development Act. During the discussion it was pointed out that lending margins were now very mature in the UK (40 bases points) and lending in Ireland would need a larger margin to cover risk. If a new approach was to work in Ireland, therefore, it would need two strands;

- Attraction of equity investors to middle income private rented housing, probably needing some tax changes and a rent index to create benchmarks;
- Attraction of debt funders into low income housing, probably requiring an initial regime of grants and public debt and a clear regulatory framework needed at an early stage to give confidence to lenders and provide stability

The potential for institutional involvement in the PRS through the funding of Housing Association style organisations is clear and should be explored further.

Residential Tenancies Act 2004

The recently introduced Residential Tenancies Act has implications for the PRS in Ireland. It became law on 19th July 2004 and provides for the implementation of reforms of the private rented sector recommended by the Commission on the Private Rented Residential Sector and accepted by the Government.

The Act introduced a set of measures to promote a more professional approach from landlords, improve security of tenure for tenants and to clarify the obligations of both landlords and tenants. Detailed clarification of the procedure for the termination of a tenancy and the appropriate period of notice help both landlords and tenants understand their rights under the granting of a new tenancy. The Private Residential Tenancies Board (PRTB) is an important feature of the legislation. An independent means of resolving disputes between landlords and tenants may be a minor factor in encouraging institutional investment. Independent mediation may avoid adverse publicity for institutions with disputes settled at an early stage.

The PRTB will, for example, deal with disputes about the refund of deposits that are currently dealt with by the Small Claims Court, disputes about breaches of tenancy obligations whether arising from the provisions of this Act or under a tenancy agreement and disputes surrounding the termination of tenancies in accordance with the provisions of this Act.

In relation to rents, the PRTB will deal with cases relating to rent arrears and disputes about whether a rent sought exceeds market rent. Dispute resolution procedures are defined. The process consists of two stages; stage one is either mediation or adjudication and is confidential, and stage two is a public hearing by a Tenancy Tribunal. The Tribunal is composed of 3 persons drawn from the PRTB's Dispute Resolution Committee. A mediated agreement or the determination of an adjudicator or of a Tribunal will result in a determination order of the PRTB. The Tribunal's determination of a matter may be appealed to the High Court on a point of law only. The enforcement of determination orders of the PRTB that are not complied with will be through the Circuit Court.

As part of the new legislation landlords are required to register all new tenancies and inform the PRTB about rent increases. The PRTB will use the data from registrations for the purpose of its information provision function and also in the resolution of certain types of disputes. These data could be collated to produce rent indices for new lettings and generally improve the availability of data on the PRS.

The Residential Tenancies Act 2004 may improve confidence in the landlord and tenant relationship with clearer procedures and guidelines. This will certainly provide a level of reassurance for investment organisations even if they do not deal directly with the day to day details of a tenancy. It will not, on its own, stimulate institutional investment but it may help overcome one of the main barriers to investment; the fear of adverse publicity.

6: Conclusions: The Future for Institutional Investment in the PRS

This final section deals with two issues:

- What overall conclusions can be drawn from the research?
- What does the future hold for Institutional investment in the Irish PRS

6.1 Overall conclusions

The evidence from the research provides a fairly consistent picture, although the quality of evidence varies. The qualitative evidence from key informants and from the literature is the most robust and is also consistent. The quantitative evidence on rents, income returns and total returns is poor, making it possible to make only limited comparisons with returns from other property investments in Ireland and from residential lettings elsewhere. The direct evidence from financial institutions is even more limited.

Nonetheless, the picture painted by the evidence is fairly consistent and there are some conclusions that can be drawn with reasonable confidence. Others are more tentative.

We can say with confidence that:

- the PRS has grown rapidly in recent years, spurred originally by tax incentives and more recently by capital growth prospects and low interest rates;
- the vast majority of PRS dwellings are owned by individual landlords, seeking capital gains; debt funding is readily available with high loan to value ratios and competitive interest rates; overseas lenders are active in the lending market; this 'buy to let' market is hence highly geared;
- most of the new supply is targeted at the middle and upper end of the lettings market; there is some evidence that supply at the lower end has fallen, and that rising rents on this limited (if not diminished) supply have led to increased rent subsidies for low income tenants;
- although financial institutions are very active in the debt market, there is no evidence of equity investment by them, nor any immediate prospects for it; some of the reasons for this are the perceived high costs (and risk to reputation) of both entering the market (in terms of transactions costs) and of management and maintenance costs, both compared with commercial property; the lack of tax transparent investment vehicles may be a factor deterring indirect investment by non tax paying institutions who do not want to own and manage residential lettings directly themselves;
- there is even less likelihood that institutions would wish to be involved directly in financing landlords in the low income sub-sector, for a combination of return and reputation risk; providing subsidies to enhance returns is unlikely to work as institutions look unfavourably upon like investments where the returns are dependent on tax breaks; tax transparency however is desired;

Because the quantitative data are poor we can say with less confidence that:

- income returns appear to be low, by comparison with other European, including UK, residential markets; this appears to be a product of the high levels of capital appreciation, as a result of which total returns are equivalent to returns from both commercial property in Ireland and residential lettings elsewhere in Europe;
- the evidence suggests that initial income returns may be unattractive to potential new corporate landlords and to equity investment by financial institutions; this barrier is significant in the light of the risk and liquidity characteristics of residential property and of its novelty; all these latter factors imply a high 'hurdle' rate of return for new corporate investors; whilst this might fall with increasing experience and familiarity with the market, it suggests that there are few, if any, immediate prospects of equity investment in the PRS by financial institutions;
- by contrast, the environment is conducive to small scale and individual investors, seeking capital gains and willing to manage property themselves; they may be content with the low net income returns, provided rents cover debt charges and other running costs, because of the long term prospects of capital

“The Residential Tenancies Act 2004 may improve confidence in the landlord and tenant relationship with clearer procedures and guidelines.”

growth and hence high total returns; as there are few, if any, investment vehicles that enable 'retail' investors to invest in residential property, becoming a small scale landlord is the best way to invest;

- as these individual landlords are 'content' with rents that cover costs, this investment pattern may 'crowd out' large scale equity investment from financial institutions that are seeking a higher initial income return.

We can also conclude that the lack of data (including time series) on rents, costs, and capital values makes an accurate assessment of competitiveness very difficult. Indeed the very lack of data may of itself be inhibiting the emergence of a corporate sector with institutional funding, since it is almost impossible to appraise investment propositions against wider market information. The development of a rent and yields index may therefore be a necessary (though not sufficient) condition for attracting investment.

The UK experience of Housing Investment Trusts suggests that tax transparency is a necessary but not sufficient condition for institutional investment (Crook & Kemp, 2002); other overseas research indicates that there can be significant economic benefits arising from the introduction of tax transparent property investment vehicles and without a significant tax loss arising (Anderson, Robertson & Scott, 2000); other countries have experience of these (Crook, 2000; Pomeroy, 1999) and the French Government has recently legislated to introduce them (Cohen, 2002).

6.2 The Future of Institutional Investment in the PRS

Chapter 5 describes five measures that have the potential to impact upon the current level of institutional investment in the PRS in Ireland. These are:

- Special Purpose Vehicles, specifically the Property Investment Fund.
- Private Public Partnerships.
- Increased data availability and the introduction of performance benchmarks in the PRS.
- Residential Tenancies Act 2004.
- Part V of the Planning and Development Act 2002 and UK style Housing Associations

New tenancies legislation has already been introduced and its potential impact was discussed in the previous chapter. The following describes whether the remaining four measures are likely to have an impact on future levels of Institutional investment and makes appropriate recommendations.

Special Purpose Vehicles, specifically the Property Investment Fund

During the writing of this report an article appeared in the Irish Times by Eunan O'Carroll from the Gunne Group (Sunday Business Post 2004). He commented that "Investors, both private and institutional, are becoming more disillusioned with stock markets following recent and continuous accountancy scandals. This leaves an investment void that needs to be filled by a suitable type of asset that can offer both good returns and financial transparency. Indeed, institutional investment in the residential sector is quite common in other EU states, such as France and Germany."

He outlined the tax disadvantages of investing in indirect property and the advantages of PIF and stated "The Gunne Group strongly encourages the Irish government to establish the legislative infrastructure that would allow products such as PIFs to come into operation in Ireland. These PIFs could revolutionise the housing market because they would attract a massive influx of investment capital from institutional investors into the residential sector. This would have the effect of increasing the quantity and quality of rented accommodation as institutional investors would manage buy-to-let properties to the highest standards in order to ensure shorter void periods. Due to the huge positive impact PIFs could have on the residential property market and the economy, we would recommend that the government afford all necessary actions to facilitate the prompt introduction of PIFs"

We also recommend that the Irish government examine the potential for PIF and introduce measures as quickly as possible to establish these funds. The UK government has set up a consultation process on PIF

due to end in July 2004 and PIF looks likely to be introduced but as with all such initiatives the timescale is unknown. PIFs in Ireland could have a significant impact on the level of institutional investment in the Irish market with the associated benefits.

Private Public Partnerships and low income housing

It is too early to say whether PPP will be successful in the PRS. A successful pilot scheme is necessary to provide institutions with the evidence they need that PPP offers good returns given the potential risk. PPP have the potential to provide accommodation for the lower income end of the PRS and for the provision of student accommodation. Institutions are risk averse organisations and tend to avoid investing in schemes or assets with an absence of a performance history. Therefore it is vital for a pilot housing PPP to be successful and the outcome publicised to encourage future investment.

Although the prospects of attracting institutional funding to landlords letting at the low income end of the market currently look very thin, it is not clear whether there are structures that could facilitate this. There is some overseas experience of using tax credits to attract equity funding to low income housing projects, although these are not without problems (Crook, 2000; Pomeroy, 1999; Holmans et al, 2002). It is possible that these could have a role to play within Ireland and its tax structures. Further research is necessary into the use of tax credits to fund low income housing.

Increased data availability and the introduction of performance benchmarks in the PRS.

This is a relatively simple measure to introduce and to a limited extent already exists. The combination of data-sets from organisations such as Sherry Fitzgerald and the Gunne group to produce a service similar to that offered by SCS/IPD for the commercial sector would provide the information institutions require to assess and structure their investments in residential property. There needs to be provision of data on investment returns; income, capital and total returns, which would provide information not only to existing small landlords, who could check the performance of their own assets against market performance, but also for larger organisations wishing to enter the market. There is commercial potential as such a service could be offered to institutions again in a similar manner to that of IPD. Additional data from the new compulsory registration of tenancies required by the new Residential Tenancies Act 2004 could provide additional data to the service.

Alone, the introduction of a comprehensive data service is not enough to attract substantial investment from institutions. However, if PIF are introduced then the service could be used to track the performance of individual properties within the investment fund reducing the potential risk of institutional investment as institutions can track performance in the PRS against returns available from alternative investments assets. We recommend the government explore ways of using the data from the new registration of tenancies to increase data availability in the sector and other organisations holding and collecting data on the PRS examine ways of organising these data on a commercial basis to provide a service to investors.

Part V of the Planning and Development Act 2002 and UK style Housing Associations

Part V of the Planning and Development Act (2002) has the potential to deliver significant quantities of social and affordable housing. There is potential for institutional involvement in the provision of social housing through this policy through the funding of Housing Association organisations. The current UK style of Housing Associations has been in place since the 1970's and has developed into a mature market where the Associations are able to secure private finance at favourable rates. This is not possible with the current structure of Housing Associations operating in Ireland and the current financial arrangements (e.g., the differential rent scheme). The government should explore ways in which institutional finance could be attracted to fund social housing based on a UK Housing Association style of organisation. During the seminar run by Threshold with banking institutions this was the main issue of interest. Additional research is required in this area but such a measure could have significant implications for the delivery of social housing and the attraction of institutional funding in the sector.

"Lack of data may of itself be inhibiting the emergence of a corporate sector with institutional funding,"

6.3 Conclusions

There is currently little potential at present for increased institutional investment in the PRS. However, this report has described a number of measures that could have a positive impact. Part V and the Residential Tenancies Act have already been introduced and, given reform of the financing of housing associations, will have a positive affect on the sector but alone will not attract institutional investment. However these measures coupled with the implementation of a PIF vehicle and increased data availability could have a significant impact on institutional investment and therefore the PRS as a whole.

The creation of organisations in the UK style of Housing Associations to deliver social housing through Part V of the Planning and Development Act could provide an additional avenue for institutional involvement in the residential market.

These positive measures and methods to implement such measures should be explored by relevant organisations in Ireland. Additional research is required to provide effective lobbying of the relevant bodies with the power to take appropriate action to facilitate these measures.