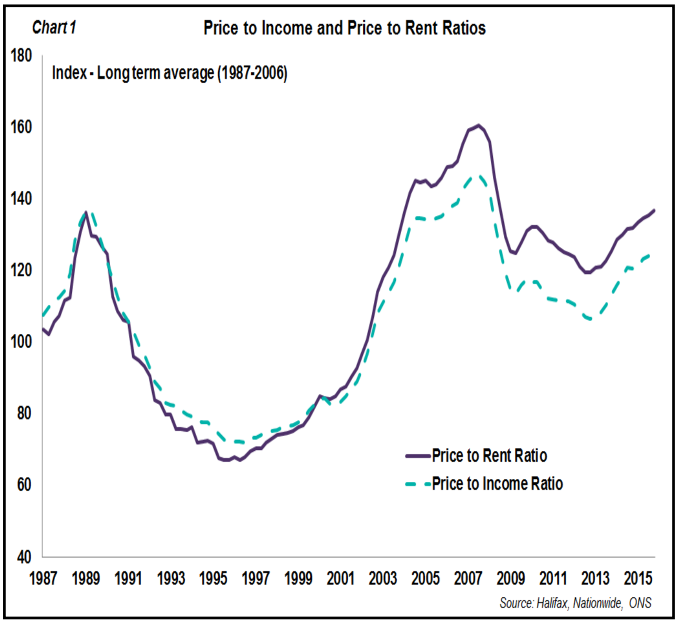
Michael Hanley
mhanley@rics.org

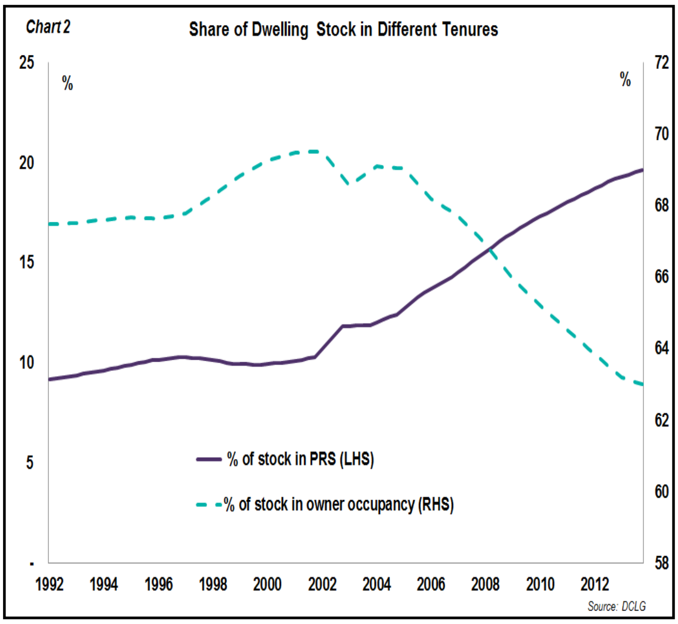
The Effect of the Buy-to-Let Mortgage on the Price-Rent Ratio

UK house prices are now above their pre-crisis peak, on most measures, and RICS lead indicators suggest that they will continue to rise through much of next year. The strong growth in recent years has led to concerns over the sustainability and affordability of current prices, which look stretched relative to many valuation metrics. Several common metrics that attempt to gauge the extent of overvaluation in the property sector are the ratio of prices to income, the ratio of debt service costs to income and the ratio of prices to rents. Chart 1 shows the price-rent and price-income ratios relative to their long term average (in this case the data has been transformed so that the long run average equals 100) over the course of the last three decades.

The legitimacy of the price-rent ratio as a measure of overvaluation rests in the user cost theory of house prices. According to this approach, in equilibrium, the rental value of housing should equal its user cost, where user cost takes account of all the costs and benefits associated with owning the property (interest payments, expected capital gains, maintenance costs, property tax, etc). In a free and flexible market, arbitrage opportunities should ensure the price-rent ratio should be mean-reverting as long as the factors influencing user cost are stable. Any permanent change in any of the above determinants of user cost can result in a change in the equilibrium price-rent ratio but a divergence in prices and rents caused by a short term change in any of these factors is deemed unsustainable and prices and/or rents can be expected to change again in future. While many doubt the legitimacy of crude metrics such as these given the changes in financial conditions in recent decades and the dynamic nature of residential property markets, they are still closely watched. Indeed, despite their simplistic underpinnings, they have proved over time to be reliable indicators of when markets are overheating.

As chart 1 shows, the price-rent and price-income ratio are both currently elevated relative to their historic trend. The substantial loosening in credit conditions over the course of the last 20 years has driven both ratios higher. While both metrics moved almost perfectly in line with each other in the 1987-2002 period, since then they have diverged with the price-rent ratio significantly higher relative to its own past rate. To see what has driven the divergence between these ratios over the last 15





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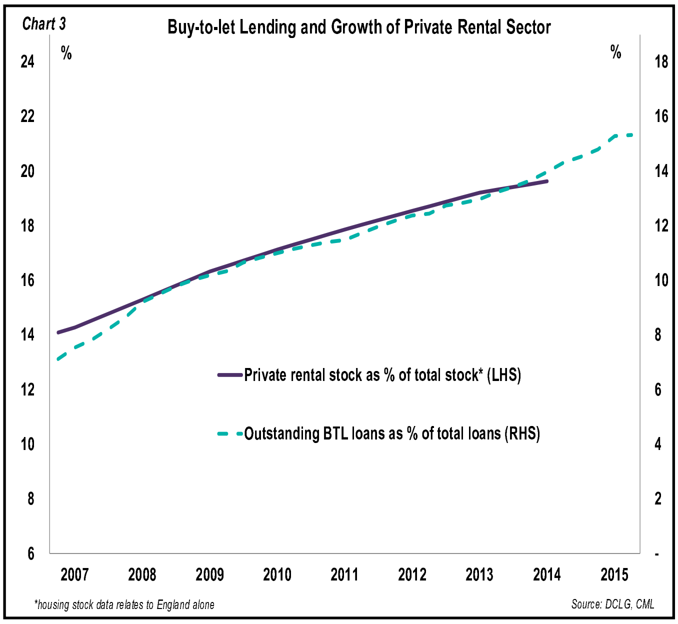
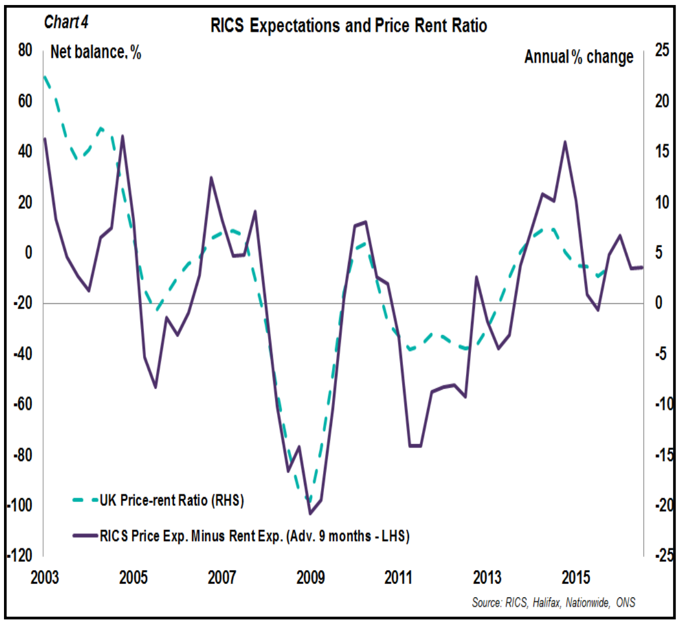
years we must look to the cause of the disconnect in the historic relationship between rents and income.

The introduction of the buy-to-let (BTL) mortgage in 1995 and it's subsequent popularisation has resulted in a doubling of the share of the housing stock being held in the private rental sector (PRS) over the course of the last 15 years. Several studies have suggested that the growth of the PRS has pushed up house prices and crowded out other buyers and through this demand channel it will have contributed to a rise in both the PR and PI ratio. However, the advent of this new source of finance for landlords also had a significant effect on the supply side of the market: Chart 2 shows the change in tenure structure in the UK housing market that resulted largely from the advent of the BTL mortgage.

The supply of housing tenures prior to the introduction of the BTL lending can be thought of as being restricted by a binding credit constraint which kept the stock of private rental properties away from society's desired level. Given that the introduction of the BTL mortgage offered a new type of buyer an entry point to a new investment market, it is likely to have resulted in an increase in supply of rental properties at a given rental yield. This credit constraint can be thought of as an additional factor adding to user cost and raising rents relative to prices. Data from the English Housing survey indicates that average private rental growth slowed in the post-2002 period. Income growth also slowed over this time, albeit to a lesser degree. More subdued rental growth relative to incomes is what would be expected following a boost to supply that leads to a more competitive rental market.

The continuing changes in tenure structure suggest that the market is still in transit towards some sort of equilibrium but given the other changes affecting the market in recent decades it would be naïve to think that this is the only factor driving this change. Indeed, the introduction of the Assured Shorthold Tenancy as the default lease type and the removal of much of the burdensome regulation of the sector were very pertinent factors attracting investors: however, in the absence of the BTL mortgage it is unlikely that the growth we have seen in the PRS over recent years would have been possible. The growth of the PRS since 2002 suggests that the lack of financing for BTL purchase was indeed a binding constraint prior to its introduction. While the ultimate equilibrium in this market will take time to unfold and has been disrupted by the financial crisis, the increased share of properties in the rental sector is likely to remain a more permanent feature of the market (see chart 3), unless policymakers actively and try to discourage this outcome.





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Some of the divergence in the PR ratio over recent years is almost certainly unsustainable given the role that ultra low interest rates have played in driving price growth. However, with rental values probably growing more gradually now than would have been the case in the absence of the BTL mortgage market, the ultimate equilibrium is likely to be higher than its long term average. Recent measures from the Chancellor, such as the new stamp duty layer and the removal of mortgage interest rate relief for buy-to-let properties will discourage investment in the PRS and are likely to also have an effect on the ultimate equilibrium PR ratio. Indeed, in a question added to the January RICS Residential Market Survey, around 50% of respondents took the view that the recent policy changes would cause landlords to reduce their property holdings. There is the chance that institutional investment could fill some of the gap if there was an exodus of private landlords and recent announcements from the likes of Grainger and L&G show their interest in the build-to-rent sector. However, individual landlords have been the backbone of this market and any significant withdrawal of investment on their part would surely be impossible to replace and would substantially change the supply/demand dynamic in the market.

Given the many changes that have affected the PRS in recent decades, the most substantial of which is surely the growth of BTL lending, it is probable that simple comparisons of the PR ratio to its historic value will result in an inaccurate measure of valuation. However, comparison of the ratio to more contemporary values still gives useful approximations to changes in affordability. As the RICS expectations data in chart 4 shows, housing affordability only looks likely to deteriorate over the coming few quarters with a higher net balance of surveyors expecting prices to rise rather than rents.

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United Kingdom RICS HQ
Parliament Square, London
SW1P 3AD United Kingdom
t +44 (0)24 7686 8555
f +44 (0)20 7334 3811
contactrics@rics.org

Media enquiries
pressoffice@rics.org

Ireland
38 Merrion Square, Dublin 2,
Ireland
t +353 1 644 5500
f +353 1 661 1797
ricsireland@rics.org

Europe
(excluding UK and Ireland)
Rue Ducale 67,
1000 Brussels,
Belgium
t +32 2 733 10 19
f +32 2 742 97 48
ricseurope@rics.org

Middle East
Office G14, Block 3,
Knowledge Village,
Dubai, United Arab Emirates
t +971 4 446 2808
f +971 4 427 2498
ricsmenea@rics.org

Africa
PO Box 3400,
Witkoppen 2068,
South Africa
t +27 11 467 2857
f +27 86 514 0655
ricsafrica@rics.org

Americas
One Grand Central Place,
60 East 42nd Street, Suite 2810,
New York 10165 – 2811, USA
t +1 212 847 7400
f +1 212 847 7401
ricsamericas@rics.org

South America
Rua Maranhão, 584 – cj 104,
São Paulo – SP, Brasil
t +55 11 2925 0068
ricsbrasil@rics.org

Oceania
Suite 1, Level 9,
1 Castlereagh Street,
Sydney NSW 2000. Australia
t +61 2 9216 2333
f +61 2 9232 5591
info@rics.org

North Asia
3707 Hopewell Centre,
183 Queen's Road East
Wanchai, Hong Kong
t +852 2537 7117
f +852 2537 2756
ricsasia@rics.org

ASEAN
10 Anson Road,
#06-22 International Plaza,
Singapore 079903
t +65 6635 4242
f +65 6635 4244
ricssingapore@rics.org

Japan
Level 14 Hibiya Central Building,
1-2-9 Nishi Shimbashi Minato-Ku,
Tokyo 105-0003, Japan
t +81 3 5532 8813
f +81 3 5532 8814
ricsjapan@rics.org

South Asia
48 & 49 Centrum Plaza,
Sector Road, Sector 53,
Gurgaon – 122002, India
t +91 124 459 5400
f +91 124 459 5402
ricsindia@rics.org