

FINANCIAL INSTITUTIONS AND PRIVATE RENTED HOUSING

A SUBMISSION TO THE BARKER REVIEW OF HOUSING SUPPLY

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Introduction

The purpose of this submission is to draw the review's attention to the results of some recent research on investment returns in the private rented sector and on the reasons for the reluctance of financial institutions to make equity investments in the sector. The note is a direct response to Issue 4 of the review brief circulated on 9th June 2003.

The note draws on several pieces of research, including those commissioned by (forerunners of) the ODPM, by the Scottish Executive, by the Joseph Rowntree Foundation and by the British Property Federation. This includes a detailed study of the fortunes of the Housing Investment Trust (HIT) initiative (see Crook & Kemp, 1999; Crook & Kemp, 2002a). The relevant publications are listed in an appendix to this submission. Much of this work has been carried out in collaboration with Prof Peter Kemp of the University of York. Between us we have conducted much of the research on the changes to the supply side of the private rented sector since rent deregulation was introduced in 1989, but he has not been involved in this particular submission. Nonetheless his contribution to the research is gratefully acknowledged, whilst all the interpretations for this submission are the author's alone.

The submission covers the following issues

- The small scale 'cottage industry' character of the private rented sector in England is illustrated by some recent survey figures;
- The reasons for the small impact of recent attempts by Government to increase the size of the corporate sector;
- Evidence about rates of investment returns;
- The reluctance of financial institutions to invest;
- Prospects for the supply side under current arrangements.

The cottage industry: the picture before deregulation

The limited national survey research undertaken on the supply side before rent deregulation was introduced in 1989 showed that the majority of the sector was owned by individual landlords, with small portfolios which they managed themselves in their spare time (see below). Moreover, landlords who had invested for commercial reasons owned only a small majority of the sector. Many others had become landlords by accident (for example, through inheritance), or to house employees, or for a wide range of social and personal reasons. The net result was that landlords who were likely to respond on a strictly commercial basis to market signals, such as higher rents, owned only a small proportion of the sector. Furthermore few landlords were large enough to realise economies of scale in management and maintenance: hence their costs per dwellings were high. Similarly, few were large enough to spread market risk through regional and market segment diversification. Finally, although the evidence was very limited, most of the landlords in the market at the time of deregulation were dependent on their own private equity, and did not draw in investment funding from the main City institutions. Most landlords bemoaned the rates of return they were earning, less than half the stock being owned by landlords

who thought their rent adequate, or that it was sufficient to cover repairs and give a reasonable return. The then Conservative government took the view that bringing in new corporate private landlords could help transform the sector.

On an international comparative basis, even if not dominant, institutional investment in private rental housing is not uncommon in many countries including, for example in Canada and the USA (Crook, 2000). In Britain, financial institutions were also important investors in private rental housing in the nineteenth century and to a lesser extent in the inter-war years. But between the 1950s and the 1970s the financial institutions sold their residential letting portfolios. This disinvestment was part of the wider process of decline in the private rental market during this period. Meanwhile, the institutions became significant investors in commercial property, such as shops, offices and factories, including through direct ownership.

Detailed evidence about the nature of the supply side before deregulation was very limited. Indeed debate was as much dominated by myth as by hard evidence. However, two large-scale social surveys, one undertaken in the mid 1970s and one in the mid 1980s, provide a base line of data for measuring the extent of subsequent change in the 1990s (Paley, 1978; Todd & Foxon, 1987, cited in Crook & Kemp, 1996a). The first survey covered the owners of a representative sample of all private lettings in the densely rented areas of England. The second survey was of the landlords of a representative sample of lettings made over the period 1982 to 1984.

The surveys revealed the following key characteristics about landlords and their opinions and policies:

- Over half of all lettings were owned by individual landlords: 55 percent of all lettings in 1976 and 60 percent of lettings made between 1982 and 1984;
- Most landlords had small portfolios: 42 percent of lettings in 1976 were owned by landlords who had fewer than 10 lettings in all throughout England;
- Despite the long term decline of private renting in preceding decades, a significant proportion of dwellings were owned by those who has become landlords in recent years: for example, 20 percent of all lettings in 1976 were owned by those who had first become landlords in the previous six years;
- Similarly a significant proportion of the most recently let dwellings had been acquired by their current landlords within a few years of these lettings: for example 30 percent of all lettings made between 1982 and 1984 had been acquired since 1980;
- However, only a minority of lettings had been acquired for investment purposes: for example 36 percent of lettings made between 1982 and 1984;
- Only a small proportion of lettings was owned by landlords who thought the law allowed them to charge a reasonable rent and adequately protected them against tenants (39 and 17 percent, respectively, of the owners of lettings made between 1982 and 1984);
- Similarly a small proportion of lettings had landlords who thought rents were adequate (for example, the landlords of only 39 percent of lettings in 1976) or sufficient to cover repairs and give a return (the landlords of 17 percent of lettings in 1976);
- Not surprisingly only a minority of lettings had landlords who would relet vacancies (only 40 percent in 1976).

Attempts to get a bigger corporate sector: Government initiatives on the supply side in the 1990s

The Conservative governments of Margaret Thatcher and John Major took a number of steps to achieve their objectives of reviving the private rented sector. To create a larger and more market-oriented sector, rents of all new lettings were deregulated in 1989 and security of tenure was modified. These changes were designed to increase landlords' returns, by making it lawful to charge market rents. By improving liquidity and lowering risk generally, it was expected that the 'hurdle' rate of return that all types of landlord required would fall. Hence, more competitive returns would remain in the sector dwellings owned by then existing landlords and would also create a framework within which new landlords would have the confidence to invest.

The Conservative government also recognised that it would take time for confidence to be restored to an industry that had been in decline for most of the previous seven decades. To help speed up the revival of the sector and to provide a 'demonstration project' of what it hoped would be a profitable deregulated and more corporate sector, the government used the Business Expansion Scheme (BES) to provide tax incentives to individual equity investors for a limited five year period for the tax years 1988-89 to 1993-94 (Crook, et al, 1991; 1995). In effect, the Government underwrote the risk that might otherwise have prevented investors entering the market.

The deregulation and tax incentive measures were introduced at a time when the housing market entered a recession, especially as far as the owner occupied sector was concerned. This had a major effect on the impact of deregulation and on the operation of the BES. Although the private rented sector expanded in the five years after deregulation (in England, from 1.8m to 2.05m dwellings), much of this can be attributed to the depression in the owner occupied market, as homeowners, unable to sell, temporarily let out their homes instead. About half the increase in the sector can be attributed to the recession (Crook & Kemp, 1996b).

Over £3,000m was invested in the 903 assured tenancy companies under the BES scheme and these companies acquired 81,000 dwellings. However, many of these companies were launched in the anticipation of shareholders making significant capital gains through increases in house prices. These would be extracted by companies selling the houses they had acquired, once the minimum five year letting period required to retain qualification for tax reliefs had expired.

Hence many of these companies had only a short-term investment horizon. Although the subsequent fall in house prices meant that many were unable to realise their original objectives within five years, it was not expected that many of the lettings owned by BES companies would be retained in the sector in the long run, especially once house prices recovered from their nominal fall.

Moreover, many of the BES companies did not acquire good quality housing. Significant proportions acquired stock possessed by mortgage lenders and sold on to BES companies as ways of placing this (often poor quality) re-possessed stock off their balance sheets. Others acquired student residences from universities because the

BES made it possible for the companies and universities to set up mutually advantageous sale and leaseback schemes. Meanwhile, the rental rates of return being earned by all these companies were not competitive. Although the largest companies achieved higher income (net rental) returns than the small ones (illustrating the presence of scale economies), these were below the benchmark returns required by companies for a long-term future (Crook et al, 1995).

Thus, the objective of using the formation of new BES assured tenancy companies to demonstrate to individual equity investors and also to financial institutions that private renting could provide competitive returns was not realised. Nor was the objective of establishing a larger corporate sector through this means realised. Moreover, the tax expenditure incurred in relation to the BES assured tenancy companies was very substantial, equating to approximately £20,000 for every dwelling the companies acquired.

In order to create a larger corporate sector and also to provide a basis for securing long run equity and debt funding from the major financial institutions, the Government launched a further initiative in 1996 designed to facilitate the securitisation of residential property investment. This is especially important because financial institutions are, with some exceptions, reluctant to own private rented dwellings directly (Crook & Kemp, 1999). Hence indirect investment vehicles are required to facilitate investment, with tax structures that are attractive to institutions, such as pension and other 'gross funds', who pay no tax on their income from directly owned property. Housing Investment Trusts (HITs) were designed to facilitate the involvement of City institutions in private renting, not through direct ownership, but through the purchase of shares in HITs, which would themselves be subject to lower rates of corporation tax and to relief from capital gains taxation. It was hoped that this would encourage the major institutions not only to buy shares in HITs but also to lend them significant sums of debt (Coopers & Lybrand, 1993, 1996, cited in Crook & Kemp 2002a).

However, HITs have not so far proved attractive to the institutions (Crook et al, 1995; Crook & Kemp, 1999, 2002a). This is for a wide range of reasons, although political risk is less of a barrier than in the past, given the commitment of the Labour government to deregulation. Although our research shows that there is much greater understanding of the sector and some willingness to provide equity and debt funding than in the past, important barriers to significant funding still exist. These include market risk, the small scale of existing portfolios and the difficulty of assembling new ones, the high costs and poor quality of property management, and the lack of market information. As a result, investors require a higher rate of return on residential than on commercial property - in part to reflect the higher risks and costs, but in part to reflect novelty.

There are also difficulties connected to the specific structure of the HITs themselves, including the fact that they are not fully 'tax-transparent' and that they are complex vehicles to structure (In part because of the rules set up by the Stock Exchange). On tax transparency issues, HITs were designed to be virtually tax transparent as they were structured to suffer corporation tax at a rate that was very close to the rate of Advance Corporation Tax (ACT). Therefore, where income was distributed (at that time with the benefit of a tax credit) non taxpayers could reclaim the ACT which

meant they suffered very little tax. However, the structures that were designed to create approximate tax transparency for HITs were undermined by unrelated reforms made in 1997 to the structure of ACT when gross funds and charities were prevented from reclaiming ACT on dividends.

For all these reasons, no HIT has yet been launched (Crook and Kemp, 1999, 2002a). Attempts have been made to set up indirect residential investment vehicles outside the HIT structure, including limited partnerships and property unit trusts, but these are very few in number to date.

Nonetheless, despite the difficulties so far of attracting major City funding into the sector and of creating a new corporate form of private rented ownership, the current government remains as committed to this, as was the previous government. Indeed, the Labour Government has regularly announced that it intends to make no changes to legislation for the deregulated sector nor to the general policy objectives about the sector. It has stressed its commitment to expanding the corporate sector and to fostering increased investment by major financial institutions. Whilst, it has also stressed that it is willing to consider whether tax measures could help, it does not want to introduce tax breaks that would distort investment choices.

In the meantime, measures taken within the industry have succeeded in attracting finance into a new 'buy to let' scheme. This scheme was launched by the Association of Residential Letting Agents (ARLA) and is designed to attract individuals into the letting business. Debt funding has been provided by mortgage lenders at high loan-to-value ratios and with properties managed by professional letting agents. The intention is to enlarge the numbers of individual landlords by making debt funding available on attractive terms and by ensuring that they are relieved on the 'hassle' of day-to-day management and maintenance through engaging competent and professionally qualified agents. The initiative has progressed far beyond the initial ARLA sponsored scheme with many mortgage lenders offering generic 'buy to let' debt funding outside the ARLA scheme to many small-scale private landlords. Recent evidence suggests that by mid 2002 there were approximately 275,000 buy to let mortgages with a total value of £24.2 billion (including re-mortgages).

The cottage industry: the picture after deregulation

Despite the very limited success of the BES and HITs initiatives in creating a more modern form of private renting involving corporate ownership and institutional funding, the sector has grown very considerably since deregulation in 1989. In England, for example, the number of dwellings increased by approximately 25 percent between 1989 and 1999 - from 1.8 million dwellings to nearly 2.3 million (similar rates of growth have been experienced in Wales; in Scotland growth has been less). There is evidence that this growth has a significant regional dimension, with growth in southern England being greater than elsewhere. This variation is probably related to both to housing market (owner occupiers being unable to sell and renting out instead) and labour market changes (increased demand for labour on short term and flexible contracts).

Despite the significant increase in the overall size of the sector since 1989, the most recent research suggests that the structure of ownership has not so far been changed. Indeed, evidence illustrated in Table 1 from key surveys in 1993/94 and 1998 shows just how little it has changed (Crook & Kemp, 1996; Crook et al 1998 (cited in Crook et al, 2000) and Crook et al, 2000).

Table 1:
Classification of Landlords: percentage of dwelling stock owned by types of landlords

	1993	1994	1998
Classification	perce nt	perce nt	perce nt
Business landlord	19	17	22
Sideline Investor landlord	34	34	32
Sideline non-investment landlord	36	27	27
Institution	11	21	19
All	100	100	100

The proportions in Table 1 are based on a categorisation of landlords that is related to their investment orientation. Business landlords are either corporate landlords or individuals for whom residential letting is their full time occupation. Institutional landlords are organisations such as churches, educational institutions. Sideline landlords are individuals for whom letting is not their main occupation. These are subdivided into those who regard their lettings as investments and those who regard their lettings in other ways, such as letting to relatives and friends or for retirement.

The evidence from these recent surveys of the landlords of representative samples of all lettings shows that only just after a half of lettings are owned by landlords with commercial motivations for owning them. For example, in 1994 business landlords owned only 17 percent of dwellings in England and 34 percent were owned by sideline landlords for investment purposes. These proportions are very similar for all three surveys undertaken in England in the 1990s. Moreover the surveys confirm just how large a proportion of the stock is owned by sideline landlords, for example 61 percent in 1994 (Crook & Kemp, 1996; Crook et al, 2000).

Thus, individual ownership still dominates the sector and has grown proportionately in scale. In 1976, 55 percent of all lettings were owned by individuals. In 1993/94, 61 percent of dwellings were owned by individuals and only 20 percent by companies. The respective percentages in 1998 were 61 percent and 22 percent. The increase in individual ownership is by no means wholly explained by the numbers of owner-occupiers temporarily letting out homes they had been unable to sell during the home ownership recession in the early 1990s.

Nor has the average size of portfolio grown. In 1993/94 it was 7 dwellings. In 1998 it was still 7 dwellings. Indeed, in 1998, 27 percent of the stock was owned by landlords who owned only a single dwelling (a higher percentage than in 1994 when it was 24 percent). Moreover, most dwellings are still managed by their owners themselves. In 1993/94 the proportion was 64 percent. In 1998 it was 70 percent. Nor have attitudes to ownership changed dramatically. In 1993/94 only 48 percent of dwellings were regarded as investments with returns coming from rental income and/or capital gain. In 1998, this proportion was 57 percent. In 1998 only 23 percent of dwellings had landlords who expected the rent to give them a return on vacant possession value, almost the same proportion (20 percent) as in 1993/94.

This does not mean that there are no new landlords. Landlords continue to enter the sector, as they have regularly done over many decades. In 1993, 24 percent of dwellings were owned by landlords who had started letting for the first time since deregulation. In 1998 the proportion was 25 percent. Most new landlords were individual and sideline landlords however and were not companies. Most had a handful of lettings: the median ownership was one dwelling.

To summarise the evidence: although the sector has grown significantly in the last decade, this has mainly come from the growth of existing, as well as the entry of new, individual landlords. Thus after a decade of deregulation, it is still a 'cottage industry' owned and managed by small scale individual landlords, few of whom have any qualifications in property, let alone in the letting business (Crook, et al, 2000). Very few can achieve economies of scale in managing and maintaining their holdings, or manage market risk through a geographically and otherwise diversified portfolio. The picture in Scotland is similar to that in England. For example half lettings in Scotland were owned by individuals and only four in ten were regarded primarily as investments (Kemp & Rhodes, 1994).

Despite the fact that the Conservative and Labour governments' objectives of increasing corporate ownership has not yet been achieved, deregulation does appear to have created much more confidence amongst landlords, with the landlords of the majority of lettings holding generally positive views about letting. Landlords cited more advantages than disadvantages about new forms of letting, especially the ability to let at market rents and to obtain possession (Crook & Kemp, 1996) and were much more positive about the legal framework for letting than in earlier decades (see above). For example, 67 percent of lettings in 1993 had landlords who agreed that the law enabled them to charge reasonable rents and a half had owners who said their rent income was sufficient to cover repairs and give them a reasonable return (Crook & Kemp, 1996).

Rates of Return

Inevitably, the achievement of the government's aims depends on landlords realising competitive rates of return. That is, returns that are comparable with returns that can be earned in other alternative investments, allowing for risk and liquidity. Given that some key current objectives have not been achieved, it is important to establish if current rates of return are inhibiting progress. Historically, rates of return on private

rented investments have not been competitive (Paley, 1978; Todd & Foxon, 1987, cited in Crook & Kemp, 1996)). Survey evidence prior to deregulation suggested that returns were below landlords' requirements and that rental returns did not cover all their costs, let alone yield a return on investment. Moreover, survey evidence since deregulation in 1989 suggests that significant proportions of the stock in the deregulated sector are owned by landlords who still do not regard rental returns as adequate. Some estimates suggest that income (net rental) returns need to rise significantly - either through higher rents or through reduced costs. This appears particularly to be the case as far as new companies are concerned and in order to attract equity investment by City institutions (Crook et al, 1995; Crook, et al 2000; Crook & Kemp, 1999).

This does not necessarily mean, however, that it is possible to speak of one 'hurdle' rate of return. Rather it is likely that there will be several, ranging from those that encourage existing landlords to stay in the market to those that encourage new landlords to enter the market, especially corporate landlords with City funding (Crook, et al, 2002b). Returns required by companies (both existing and new landlords) will also 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).

Information on current rates of return is crucial in identifying the size of the gap that may exist between actual and required returns. Information on the existence, size, and reasons for that gap can help identify appropriate responses from within the industry as well as by government. The existence of such gaps does not necessarily require government subsidy or grant to bridge it. Simply providing more information about existing rents, costs, and returns may be of itself important. Research suggests that the relative lack of information about existing returns being earned (compared with the information available in the commercial property sector) itself enhances required returns, since the uncertainty raises investment risks (Crook & Kemp, 1999). Hence producing reliable and regular data on such matters, on a basis that enables intra and inter industry comparisons to be made may, of itself, increase investment.

However, it is also important to note that existing returns may not be a guide to the future for a number of reasons. First, current rents may be set at levels which are explicitly set simply to cover the costs of the majority of landlords who have non-commercial reasons for being in the sector (and who look after their own property in their own time), rather than to also give them an investment return. Second, deregulation of the sector is only relatively recent and it takes time for newly emerging markets to mature; hence the rents being charged and costs being incurred may reflect residual market imperfection and be no long-term guide to rents and returns in the future. Third, operating costs are higher than for commercial property, but if more larger companies emerge that are able to achieve economies of scale in management and maintenance, these costs should fall, so that current income (net rental) returns may be no guide to the future.

Table 2:
Income and total returns from residential lettings, other property, and financial investments in 1998

Private Lettings in England in 1998	Net (Income) Return	Total (Nominal) return
Deregulated lettings (1)	7.3 percent	10.6 percent
Retail (2)	6.5 percent	11.6 percent
Office (2)	7.9 percent	11.6 percent
Industrial (2)	9.2 percent	13.2 percent
Equities (2)	2.8 percent	13.7 percent
Long dated gilts (2)	6.4 percent	25.0 percent
Treasury Bills (2)	7.9 percent	7.9 percent

TABLE 2 ABOUT HERE

With these caveats in mind, the figures in Table 2 suggest that income returns from residential lettings in general perform poorly compared with other investments. The evidence comes from a survey of the landlords of a representative sample of all lettings in England (Crook, et al, 2000) and from a further analysis of the data (Crook, et al, 2002b). The data includes the gross rent for all sample lettings, the management and maintenance costs for each letting, the purchase price landlords paid for each letting, and their estimate of vacant possession values. The data was used to calculate income (net rental returns) and total returns. The latter includes capital value increases as well as income returns. Capital value growth can be expressed in two ways: annualised real capital gains or nominal gains. Estimates of return from commercial property and financial investment uses the latter basis for capital growth and this has been used in the calculations in Table 2.

The table shows that income (net rental) returns from deregulated lettings performed better than net income returns from retail property but worse than other property. It also performed better than equities and long dated gilts, but worse than Treasury Bills. As far as total (nominal) returns are concerned, deregulated lettings performed poorer than all other property and financial investments, with the exception of Treasury Bills.

Conventionally, residential lettings are seen as higher risk and lower liquidity than other property assets and all financial assets. If this is a correct assessment, residential lettings perform poorly on the basis of the above figures, since a higher return would be required to compensate for the greater risk and lesser liquidity. However, recent years have seen a reduction in the risk on residential lettings as the market has become more knowledgeable of the sector and has learned to better

manage market and specific risk. Recent years have also seen a reduction in illiquidity since deregulation increases the certainty of landlords gaining vacant possession of property. Investment timing is important, especially in relation to capital growth cycles. Other evidence also suggests that most potential investors examine the manner in which assets contribute to their whole portfolio, rather than examining returns 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).

Conclusions: prospects for the next decade

The evidence in this Chapter shows that although the private rented sector has increased in size since deregulation, a significant part of this increase appears to have been due to the property slump of the early 1990s, while there has been no increase in corporate ownership, nor in 'City' equity funding. Although landlords are much more confident about the lettings business than before deregulation, income and total returns do not appear sufficient to attract residential property companies backed by the major financial institutions with equity and debt funding. Government initiatives to stimulate this have not worked.

There appears to be little prospect of a significant change over the next few years. There seems little chance of significant corporate investment, but it is equally unlikely that the sector will decline in overall size. The remaining regulated sector will 'wither of the vine' and statistically is likely to be replaced by additional 'buy to let' investment made by individual landlords, primarily looking for capital growth, and prepared to accept modest income returns, especially if they manage the properties in their own spare time. Hence the 'cottage industry' character of the private rented sector will remain largely unchanged, although it is likely to be more professionally managed, with the growth of more professionally accredited managing agents.

The fact that the sector has not drawn in more significant sums of corporate investment since deregulation is due to the lack of indirect investment vehicles for both retail and for corporate investors. At the moment, residential lettings provide a reasonably attractive investment for small-scale individual landlords, looking for capital gains and willing to look after property in their spare time. On the evidence of other surveys that suggests financial institutions look for total returns of 15 percent (Crook and Kemp, 1999), the current market is not, however, providing what most potential corporate investors currently require. This suggests that the next decade is most likely to look much like the last.

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SOME RELEVANT PUBLICATIONS

Crook, ADH & PA Kemp (1991) The Business Expansion Scheme and Rented Housing York, Joseph Rowntree Foundation

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