

# The UK private rented sector and buy-to-let market 2011



The Private Rented Sector...  
currently home to one in six households

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## Challenges and opportunities

The Paragon Group of Companies is the UK's leading specialist provider of buy-to-let mortgages. We have over 16 years' experience in the sector, having launched our first mortgage for residential property investors in 1995. We are a leading authority on the buy-to-let sector, with approximately £10 billion of assets under management and 40,000 landlord customers.

This paper examines the state of the UK buy-to-let market in 2011 and how it has influenced the wider Private Rented Sector (PRS). We look at buy-to-let's strong growth and how it was affected by the credit crunch. We examine the contribution of both buy-to-let and the PRS to the UK housing mix, and analyse the role privately rented housing will play in the coming decades as population growth and housing supply diverge.

We also explore the factors that are important for the expansion of the PRS, including the availability of buy-to-let finance, the recovery of the wholesale funding markets and a regulatory environment that encourages landlords to invest in the sector. It is estimated that the PRS is worth over £500 billion - more than the UK commercial property sector.

Socio-economic and demographic changes, such as a growing and transient population, are increasing demand for private rented property. The perception of renting is changing – it is increasingly seen as a tenure of choice. Many more people are renting over the long term as a lifestyle choice and we believe that the UK could soon mirror other international markets, such as the US, France and Germany, where the PRS houses a greater percentage of the population.

Paragon believes that the PRS has the potential to expand significantly over the next 10 years, and could overtake social housing to become the UK's second largest housing tenure. In order to do that, the UK needs a vibrant and healthy buy-to-let market.

### **Nigel S Terrington**

Chief Executive

Paragon Group of Companies PLC

*"We examine the positive contribution of both buy-to-let and the PRS to the UK housing mix, and analyse why privately rented housing will play an increasingly important role in the coming decades as population growth and housing supply diverge"*

*"PRS has the potential to expand significantly over the next 10 years"*

## Executive summary

*"The perception of renting is changing; it is increasingly seen as a tenure of choice"*

*"Demand from landlord investors remains robust"*

- Buy-to-let finance has been the catalyst for the revitalisation of the modern Private Rented Sector (PRS). The flow of capital into the sector has helped drive up standards and choice for tenants.
- 3.4 million households in England now class the PRS as home, an increase of 1.4 million since 2001, representing nearly one in six households. Private renting is the only growing tenure type – both owner-occupation and social housing have been in decline for the best part of the last decade.
- The PRS is a popular choice with transient sectors of the population, including students, economic migrants and those who relocate for employment purposes, in addition to people who choose rented accommodation for lifestyle reasons. The perception of renting is changing; it is increasingly seen as a tenure of choice.
- Long term demand for the PRS is forecast to rise, fuelled by major socio-economic factors. These include positive net migration, growing numbers of single person households, people starting families later in life and an increase in the age of first-time buyers.
- Recent reforms to the social housing sector are likely to increase demand for PRS accommodation and increase pressure on landlords.
- The current economic environment is placing severe pressure on the PRS, with rising levels of tenant demand outweighing existing stock. Department for Communities and Local Government (DCLG) figures show a 300,000 jump in the number of households in the sector between 2009 and 2010. This is filtering through to rental inflation.
- The UK population is expected to grow to 71.6 million by 2033 but housing supply is failing to keep pace. It has been estimated that 290,500 new homes will need to be built each year to satisfy demand. Only 102,570 homes were built in England last year.
- Demand from landlord investors remains robust. Association of Residential Letting Agents' data shows that twice as many landlords plan to buy in 2011 than sell, whilst the Royal Institution of Chartered Surveyors' Residential Lettings Survey revealed that just 4% of landlords plan to sell at the expiry of a tenancy.

- Buy-to-let is a sector in recovery. According to the Council of Mortgage Lenders, the value of buy-to-let lending in 2010 rose by 22%. This return to growth follows a 73% decline in the number of gross advances between 2007 and 2009.
- Buy-to-let mortgage product numbers remain 90% lower than 2007 levels, but availability has improved over the past year. The number of lenders in the market increased by 20% during 2010, and both product availability and criteria improved during the year.
- Arrears in the buy-to-let market are expected to continue to decline during 2011 with landlords benefiting from stable economic conditions, low interest rates and high levels of tenant demand. Buy-to-let arrears have only been above those in the wider mortgage market for three quarters since the Council of Mortgage Lenders began collating the data in the late 1990s.
- The role of 'novice' landlords in the PRS has been overstated. The DCLG's Private Landlords Survey shows that three quarters of landlords are either individuals or couples, with nearly half having between six and 20 years' experience.
- The Government must foster a regulatory environment that encourages continued investment in the PRS by landlords. The Coalition Government has shown a good understanding of the PRS and has stopped further layers of landlord regulation. However, the UK should continue to recognise that landlords operate as small businesses, and maintain its recognition of the purchasing and financing of PRS property as a commercial activity.
- The main obstacle to returning to a fully functioning buy-to-let market remains the dysfunction in the wholesale funding markets. However, there have been clear signs of improvement in this area, with a significant increase in the number of Residential Mortgage Backed Securities deals between 2009 and 2010. There was £60 billion of primary issuance in 2010 compared to £10.5 billion the previous year, and 2011 has begun in a strong fashion.

*"Buy-to-let is a sector in recovery. According to the Council of Mortgage Lenders, the value of buy-to-let lending in 2010 rose by 22%"*

## Introduction

*"Buy-to-let is a UK success story – strong growth allied with excellent credit performance. The sector is helping to meet genuine consumer demand, improving both choice and standards for tenants, whilst providing an alternative asset class for investors wanting diversification"*

*"Reliance on the PRS is set to grow"*

Buy-to-let finance has been the catalyst for the revitalisation of the modern Private Rented Sector (PRS) in the UK. The flow of fresh capital modernised a tired and decaying sector, driving up standards of accommodation and choice for tenants. The PRS now provides a home for nearly one in six households, and its importance will increase in future years as population growth and housing completions diverge. Capital Economics, a leading economics consultancy, forecasts this will rise to almost one in five by the middle of the decade.

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As with all sectors of the mortgage market, buy-to-let was impacted by the credit crunch and landlords have encountered a shortage of mortgage finance, crucially at a time of unprecedented demand for private rented property. A constrained PRS is resulting in rental inflation, potentially pricing the most vulnerable tenants out of the sector.

However, positive signs emerged during 2010. Gross advances grew by both volume and value, and the number of lenders operating in the market increased, creating much needed competition. The sector starts 2011 rejuvenated and with renewed confidence.

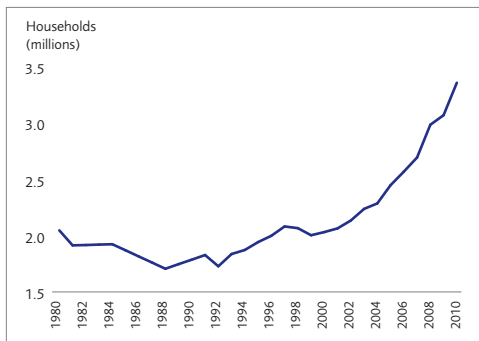
There is an expansive and willing landlord investor base that requires buy-to-let finance to ensure the PRS can continue to meet the needs of today's modern housing market. The challenge for the buy-to-let market now is meeting both landlord investor and tenant demand. Reliance on the PRS is set to grow and the UK needs a fully functioning, vibrant and healthy buy-to-let market to enable it to expand.

# Importance of the Private Rented Sector

## The Private Rented Sector today

The UK Private Rented Sector (PRS) is becoming a tenure of choice, and demand is forecast to grow. Government statistics show that 3.4 million households in England now class the PRS as home – an increase of 1 million, or 37%, since 2005. The PRS currently houses 15.6%, or nearly one in six, of all households in England, up from 11.7% in 2005.

Conversely, both owner-occupation and social housing are falling. The proportion of households in owner-occupation decreased from 70.4% in 2001 to 67.4% by 2010, with social housing households falling from 19.5% to 17%. The falling number of social housing properties in the UK – which fell by 10% between 1999 and 2009 – means that, for many, the PRS is now the only real alternative to home ownership. The social housing sector is expected to contract further over the next few years.



## Households in the PRS

"Nearly one in six households now live in the PRS"

Source: Communities & Local Government

*"Owner-occupation and social housing are in decline"*

*"Almost nobody talks about the private rented sector, and it has a vast remit in terms of people who rent privately and choose never to buy, and also from a social housing perspective. I think the private rented sector is almost the unsung hero of the housing market"*

*Grant Shapps MP  
Housing Minister*

The PRS meets both the needs of those who want long-term accommodation and those requiring flexibility. A fifth of tenants have been in privately rented accommodation for five years or more.

It is also a popular housing tenure for transient sections of the population, including students, economic migrants and the economically mobile, in addition to people who choose rented accommodation for lifestyle reasons. Its contribution was recognised by Housing Minister Grant Shapps, who said in October 2010:

*"Almost nobody talks about the private rented sector, and it has a vast remit in terms of people who rent privately and choose never to buy, and also from a social housing perspective. I think the private rented sector is almost the unsung hero of the housing market."*

*"The PRS provides a home for a diverse range of demographic and social groups. According to the Department for Communities and Local Government's English Housing Survey, single person dwellings are the most common type of household in the PRS, accounting for 29% of total numbers. This is followed by couples (26%) and couples with dependant children (18%)"*

*"Capital Economics, a leading economic consultancy, forecasts that the number of households living in the sector will increase from 15.6% at present to 17% by 2015"*

The perception of renting is changing – it is no longer seen as the tenure of last resort. Many people are renting over the long term as a lifestyle choice and the UK could soon mirror other countries, such as the US, France and Germany, where the PRS houses a greater percentage of the population.

The PRS provides a home for a diverse range of demographic and social groups. According to the Department for Communities and Local Government's (DCLG) English Housing Survey, single person dwellings are the most common type of household in the PRS, accounting for 29% of total numbers. This is followed by couples (26%) and couples with dependant children (18%).

The report also shows that a wide range of age-groups live in PRS property, which dispels the myth that the sector is the domain of just the young. Although half of private renters are aged 34 or under, 22% are in the 35-44 age group, 14% in the 45-54 age group and 14% are over the age of 55.

It encompasses a varied range of economic groups – 60% of households are in full-time employment, 9% in part-time work, 7% are unemployed, 8% are retired and 11% are classed as 'other inactive'.

### **The growing reliance on the PRS**

The PRS will play a more prominent role in the UK housing market in both the short and long term. Capital Economics, a leading economic consultancy, forecasts that the number of households living in the sector will increase from 15.6% at present to 17% by 2015. If social housing contracts at current rates, and it is likely to do so given Government spending cuts and other reforms to the social housing sector, this will make the PRS the second largest housing tenure in the UK.

Tenant demand has flourished over the past three years as people have been unwilling or unable to purchase a home. The Royal Institution of Chartered Surveyors (RICS) Residential Lettings Survey showed 32% more surveyors reported a rise in tenant demand rather than a fall during the fourth quarter of 2010, whilst Association of Residential Letting Agents' (ARLA) research shows 71% of members report more tenants than available rental properties. Meanwhile, Paragon's research of landlords shows 52% believe tenant demand will grow during 2011.

This is filtering through to rental inflation. RICS' Residential Lettings Survey showed that the rate of rental growth is at an all time high, with 40% more surveyors reporting an increase in rents in Q4 2010 than a fall. Meanwhile, LSL Property Services' Buy-to-let Index showed that rents rose for 10 consecutive months in 2010.

*"RICS' Residential Lettings Survey showed that the rate of rental growth is at an all time high, with 40% more surveyors reporting an increase in rents in Q4 2010 than a fall"*

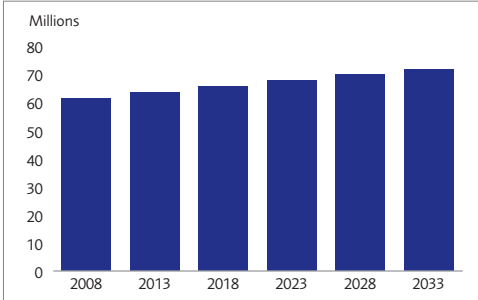
There are several important socio-economic and demographic changes signalling a long-term shift in demand for private rented property, including:

**Population growth and housing completions**

The Office for National Statistics projects that the UK population will grow from 61.7 million today to 65 million by 2016 and 71.6 million by 2033. The number of new households in England alone is forecast to grow by 6.3 million to 27.8 million by 2031, which equates to 252,000 new households a year. One person households are also projected to increase by 163,000 a year, accounting for two thirds of the increase in households, and this group has a greater propensity to rent.

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However, new house completions are not keeping up with household formation. Although it has been estimated that the UK requires 290,500 housing completions a year to 2031, housing starts and completions are falling woefully short. There were only 102,570 homes built in England in 2010, according to statistics from the DCLG.



**UK population growth forecast**

"The UK population is expected to grow to 71.6m by 2033"

Source: Office for National Statistics

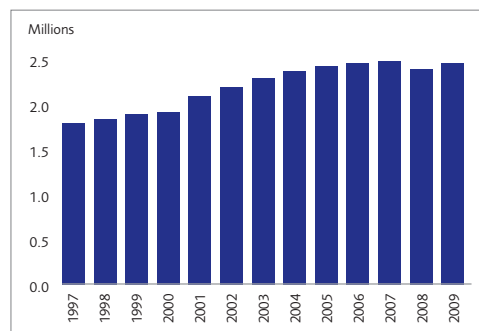
*"UCAS, the applications service, reported a record number of applicants for the 2010-2011 academic year and applications for the 2011-2012 year are already up by 5.5%"*

*"According to 2010 research from university analysis service Push, students who started university in the 2010/11 academic year can expect to graduate with a debt of £25,000, and student debt now tops £5,000 for each year of study, with the increase in tuition fees a major contributor"*

### Students and debt

Student numbers are also placing upward pressure on private rented stock. There have been increases in the number of students entering higher education over the last 10 years and the recent recessionary environment has also contributed to the acceleration of student applications. UCAS, the applications service, reported a record number of applicants for the 2010-2011 academic year and applications for the 2011-2012 year are already up by 5.5%.

Not only do students require private rented housing while at university, the rising level of student debt is making post-graduation house purchase even harder. According to 2010 research from university analysis service Push, students who started university in the 2010/11 academic year can expect to graduate with a debt of £25,000, and student debt now tops £5,000 for each year of study, with the increase in tuition fees a major contributor.



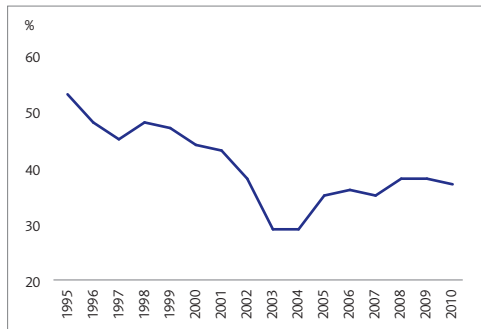
### Students in higher education

"The number of students in higher education rose over the last 10 years"

Source: Higher Education Statistics Agency

### Decline of first-time buyers

Rising levels of graduate debt is just one of the factors behind the falling proportion of first-time buyer numbers. Affordability constraints, lifestyle choices and a lack of suitable mortgage products have all contributed to a decline in first-time buyers. CML figures show that the proportion of purchasers who are first-time buyers has fallen from 55% in 1994 to 37% in 2010, whilst the average age of first-time buyers, without financial help from relatives, is 37 years. With financial help, this figure stands at 31 years.



### First-time buyers as a proportion of purchasers

"The proportion of purchasers who are first-time buyers has fallen from 55% to 37%"

Source: Council of Mortgage Lenders

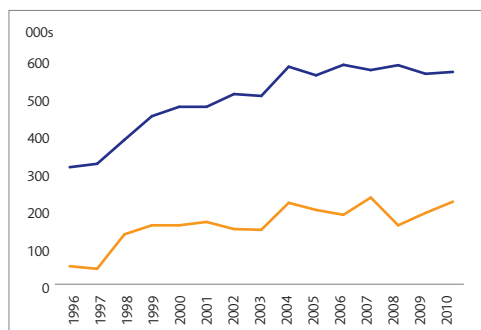
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Whilst aspiration to purchase has not fallen amongst first-time buyers, the ability to buy has. One in six private renters aims to eventually purchase a property, but of these 42% do not expect to buy for at least five years and only 14% expect to buy within the next two years. First-time buyers have been hit hard by the credit crunch – the average loan-to-value fell from 95% in 1994 to 77% in 2010, meaning first-time buyers are required to find much larger deposits to fund a purchase. Nationwide Building Society estimates that it will take eight years for an average earner to save a deposit for an average property.

### Net migration

The expansion of the European Union and the movement of labour to the UK mean net migration from new EU member states continues to be a key influence on population growth, and the majority of inward migrants opt to live in privately rented accommodation. According to the Council of Mortgage Lenders (CML), only 21% of inward migrants become homeowners within five years of living in the UK.

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### Migration to the UK

— Net migration  
— Immigration

"The long-term forecast for net migration is 190,000 a year"

Source: Office for National Statistics

*"The CML has forecast that gross mortgage lending will be flat in 2011 because of funding issues faced by lenders and limited consumer demand due to economic uncertainty"*

Net migration in 2010 was 226,000 and the long-term forecast for net migration is 190,000 a year. But it is not only new migrants who are affecting population growth. Whilst the birth rate overtook net migration as the main source of population growth for the first time in a decade in 2008, 56% of the increase in births was attributable to immigrant families.

#### **Owner-occupier mortgage drought**

There continues to be a lack of affordable mortgages available in the owner-occupier sector. The CML has forecast that gross mortgage lending will be flat in 2011 because of funding issues faced by lenders and limited consumer demand due to economic uncertainty. Banks that received financial support from the Government during the credit crunch have started repaying the various lending support schemes, whilst also contending with more stringent capital requirements under new European laws. In addition, the Financial Services Authority's Mortgage Market Review consultation is already influencing lender behaviour and the market has seen the withdrawal of interest-only products for first-time buyers by several high profile lenders.

In its 2011 forecast, the CML said:

*"The economy – and housing and mortgage markets – have made significant progress since the financial crisis of two years ago and now appear to be on a more stable footing. But recovery has been patchy and weak. The supply of funds to the mortgage market remains much more limited than before the crisis, and households are much less confident about taking on large-scale borrowing commitments.*

*"These factors, along with the regulatory constraints imposed by increased capital requirements and the possibility of rule changes being considered by the FSA, have influenced our forecasts for next year. Activity in housing and mortgage markets is set to remain broadly flat in 2011 and we do not envisage a return to the lending levels that characterised the middle of the last decade for many years to come."*

### Declining social housing stock

The stock of UK social housing has been in decline for the past three decades as a result of right-to-buy, falls in capital funding and stock transfers. Between 1991 and 2009, the number of properties in the sector declined by 1 million to 4.9 million. Social housing as a proportion of total housing stock declined from 24.8% to 18% over the same period and is expected to decline further.

The Government announced in its October 2010 Comprehensive Spending Review a shake-up of UK social housing, which included:

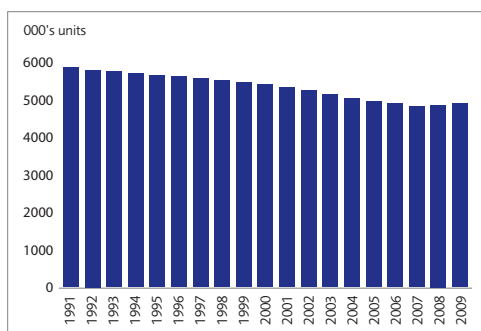
- An end to the council house for life
- Flexible tenancies
- Social housing rents at 80% of market rates rather than 50%
- A 60% reduction in the social housing budget and plans to build fewer social homes than previously forecast

This will mean a greater role for the PRS in housing people on lower incomes. The decision to move social housing rents more in line with the market rate will make private rented property an option for people who would not have previously considered it, whilst the end of social homes 'for life' will result in a higher turnover of social housing stock.

The reduction of social housing stock has increased pressure on the remaining property in the sector. DCLG figures show that there were 1.8 million households on the social housing waiting list in 2010, up from 1 million in 2000.

*"Between 1991 and 2009, the number of properties in the sector declined by 1 million to 4.9 million. Social housing as a proportion of total housing stock declined from 24.8% to 18% over the same period and is expected to decline further"*

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### Decline in the number of social housing properties

"The number of social homes has fallen by one million"

Source: Communities & Local Government

*"The analysis speculates that if current trends continue, the proportion of households in the PRS could reach 21% by 2020 and 26% by 2030. Capital Economics argues that from an historical perspective there is no reason for that not to happen given that the percentage of households in the PRS were above that level in the 1960s, plus the UK's PRS is small compared to the European market"*

#### **Under pressure - the forecasted growth of the PRS**

Capital Economics is a leading economic consultancy. Its analysis of the PRS shows that 17% of households could potentially be living in privately rented accommodation by 2015.

It states:

"Over the next three to five years, the public sector spending cuts look set to create a growing number of disadvantaged households and a shortage of social housing. In addition, the lack of mortgage credit and the sheer scale of the house price adjustment still to come, suggests that homeownership will remain no more than an aspiration for many young and low income households."

It argues that the three key recent drivers of the PRS have been rising student numbers, positive net migration and people being unable to get on the property ladder. Looking forward, it also speculates that PRS demand may increase from retired households because of inadequate retirement incomes.

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## UK buy-to-let market

### Buy-to-let and its support of the Private Rented Sector

Buy-to-let and the Private Rented Sector (PRS) are often confused as being one and the same, but the PRS has always been in existence and was the dominant housing tenure in the early twentieth century. However, for the greater part of the century the sector was in long-term decline, caused by a combination of growth in owner-occupation and the increasing role of the State as a landlord through local authority housing.

The PRS was inhibited by a restrictive regulatory regime that disincentivised investment by landlords. Regulated rents undermined returns and tenant legislation limited landlords' right to recover their property from a defaulting tenant. The 1988 Housing Act was the catalyst for change, boosting landlords' confidence in the sector by assuring their absolute right of possession. However, the introduction of buy-to-let mortgages in 1995 was the main driver of growth in the sector. It generated a significant injection of fresh finance into the PRS by creating a product that was more tailored to landlords' requirements than traditional commercial finance.

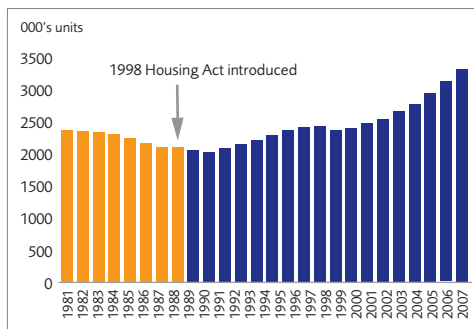
Buy-to-let has increased choice for tenants. Between 1991 and 2007, the number of properties in the sector increased by 64%, rising from 8.5% to 12.3% as a proportion of total housing stock. As highlighted earlier, the number of households has also risen significantly, rising by 1.4 million since 2001 to 3.4 million.

The majority of this growth occurred after buy-to-let was introduced in the mid-nineties and particularly during the last decade. Between 1999 and 2007, the number of outstanding buy-to-let mortgages grew from 73,200 to 1.03 million, with the value of mortgages outstanding increasing from £5.4 billion to £121 billion over the same period. This coincided with a period of strong economic growth and an increase in demand for flexible, high quality rented accommodation amongst several demographic groups.

*"Buy-to-let has increased choice for tenants. Between 1991 and 2007, the number of properties in the sector increased by 64%, rising from 8.5% to 12.3% as a proportion of total housing stock"*

*"According to the DCLG's English House Conditions Survey, the number of homes in the PRS classed as 'decent' rose by 59% between 1996 and 2006, whilst owner-occupied stock considered decent increased by only 26% over the same period"*

*"The value of buy-to-let lending grew by 22% in 2010 to £10.4 billion, with the number of loans up by 10% at 102,000. Overall, there are currently 1.3 million outstanding buy-to-let mortgages, worth £152 billion"*



### Buy-to-let and its support of the PRS

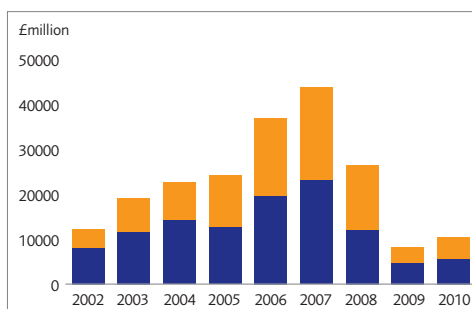
"The expansion of the PRS coincided with the introduction of buy-to-let"

Source: Communities & Local Government

As the market has grown, the quality of rental stock has improved as landlords have been encouraged to invest in their property. According to the DCLG's English House Conditions Survey, the number of homes in the PRS classed as 'decent' rose by 59% between 1996 and 2006, whilst owner-occupied stock considered decent increased by only 26% over the same period. This is reflected in tenants' view of their home – Government figures show that 83% of private renters are either 'very satisfied' or 'satisfied' with their home.

### A market in recovery

The buy-to-let mortgage market is a sector in recovery and is recording growth again after two years of dramatic declines in gross lending and product availability. The value of buy-to-let lending grew by 22% in 2010 to £10.4 billion, with the number of loans up by 10% at 102,000. Overall, there are currently 1.3 million outstanding buy-to-let mortgages, worth £152 billion.



### Buy-to-let gross advances by value

"Buy-to-let advances jumped by 22% in 2010"

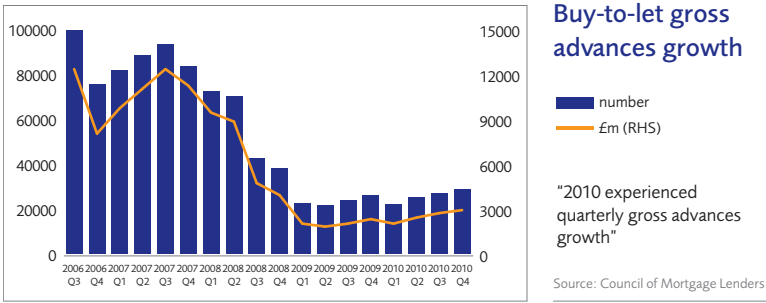
Source: Council of Mortgage Lenders

Like all sections of the UK mortgage market, buy-to-let was impacted by the credit crunch. The number of buy-to-let gross advances declined by 73% from 346,000 in 2007 to 93,500 in 2009, with the value of those loans falling from £44.6 billion to £8.5 billion, an 81% decrease. This was the lowest level since 2001. The number of buy-to-let gross advances for house purchase fell by 70% over the same period to 55,780, whilst remortgage business was harder hit, falling by 78%. This prevented landlords from obtaining the necessary finance to expand their portfolios and has resulted in rental inflation and a shortage of property supply.

2010 saw a solid improvement but the sector is still operating short of 'normal' market conditions. In the medium-term, it is unrealistic to expect lending levels to return to 2007 numbers. This was an unprecedented period in the global economy, when mortgage markets around the world had access to cheap finance and, for some, market share was more important than risk management. Datamonitor forecasts that buy-to-let lending levels will reach £25.6 billion by 2014. Whilst this timing is on the optimistic side, Paragon views long term sustainable levels of lending at being between £25 billion and £30 billion a year for the sector in normal market conditions.

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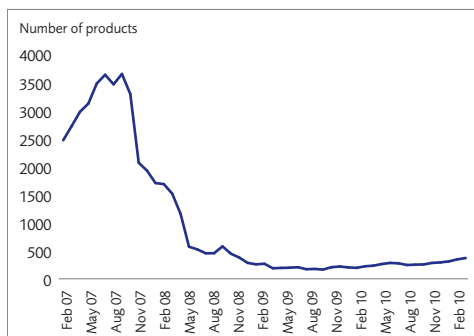
*"There were 3,648 buy-to-let products available at the peak of the buy-to-let market in July 2007 – today there are approximately 330, a reduction of more than 90%"*



**Mortgage finance availability**

There were 3,648 buy-to-let products available at the peak of the buy-to-let market in July 2007 – today there are approximately 330, a reduction of more than 90%. Not only are there fewer products, criteria is tighter and products are generally aimed at smaller scale landlords. In August 2007, 65% of buy-to-let products had a maximum loan-to-value (LTV) of 80% or higher – today approximately 4% of products have an LTV of that level. Nearly half of the current range of products (47%) offer a maximum LTV of 65% or under.

*"There was a 20% increase in the number of lenders competing in the market in 2010, whilst product numbers jumped by over 50%"*



**Available buy-to-let products**

"Product availability is 90% down on the market's peak"

Source: Moneyfacts

However, the market has seen recent improvement. There was a 20% increase in the number of lenders competing in the market in 2010, whilst product numbers jumped by over 50%. 2010 saw the launch of several new lenders into the market, such as Precise Mortgages, Aldermore and Tiuta, as well as the return of more established names, including Paragon Mortgages. This has created a renewed sense of competition and given landlords choice once again. A clear sign of this is the upsurge in lenders advertising in specialist trade magazines; something that was absent during 2009.

A key moment for the market was the launch of 80% maximum loan-to-value products by The Mortgage Works, one of the sector's largest players, in 2010, which displayed lender confidence in buy-to-let and the PRS.

BUY-TO-LET CRITERIA		
MAX LTV	% OF TOTAL PRODUCTS AUGUST 2007	% OF TOTAL PRODUCTS MARCH 2011
90%	12.8%	0.0%
85%	52.0%	0.3%
80%	12.8%	3.9%
75%	15.4%	48.7%
65%	5.1%	27.8%
60%	1.2%	19.3%

Source: Moneyfacts

Overall, the buy-to-let sector is still a long way from 'normal market conditions', but it made great strides during 2010, displaying renewed confidence and lustre. The sector must now carry that on through 2011.

**Strong credit quality**

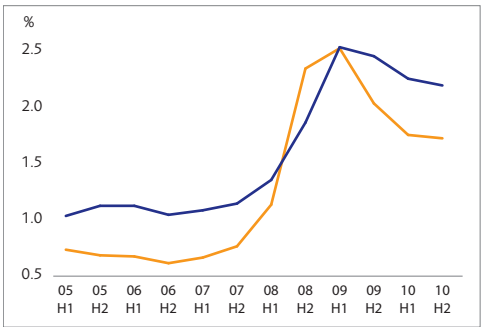
A common accusation levelled at the buy-to-let market pre-credit crunch was that it was untested in recessionary conditions. After the worst economic environment for nearly 60 years, buy-to-let has been severely stress-tested and has proved its resilience.

Along with the rest of the UK mortgage market, arrears rose as the crunch bit, but from a very low base and not to the level forecast by some commentators. Buy-to-let arrears have been in decline since Q1 2009 after increasing in consecutive quarters during 2008, and once again sit below arrears in the wider mortgage market. Arrears in the buy-to-let market have only been higher than the wider mortgage market for three quarters since the CML started collecting the market's data in the late 1990s.

Buy-to-let 3 month+ arrears increased from 0.92% in Q1 2008 to 1.56% in Q3 2008, and peaked at 3.06% in Q1 2009. However, arrears subsequently subsided and currently stand at 1.69%. Paragon's arrears have consistently outperformed both the buy-to-let market and wider mortgage sector, standing at 0.83% by the end of 2010.

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**Buy-to-let and mortgage market arrears**

— CML buy-to-let  
— CML all mortgages

"Buy-to-let arrears have historically been lower than the wider market"

Source: Council of Mortgage Lenders

*"Receiver of Rent has clear benefits for tenants. When a lender appoints a Receiver, it honours the tenant's rights under the terms of their contract and ensures that the property is professionally managed and maintained. This secures the tenant's position, protects the property and guarantees the rent payment profile"*

Buy-to-let lenders can utilise the Receiver of Rent process under the 1925 Law of Property Act when an account falls into arrears, enabling them to appoint a Receiver to take control of the property and collect the rental payment direct from the tenant to pay down the arrears. Once the arrears have been cleared, the control of the property can be handed back to the landlord if appropriate.

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## Landlords

### Who are the UK's landlords?

Landlords cannot be treated as an homogenous group and there is no such thing as a typical landlord. Landlords are usually equated with buy-to-let investors but as only a third of PRS properties have a buy-to-let mortgage, that assumption is too simplistic.

What we do know about landlords who have purchased property with a buy-to-let mortgage is that they do not invest for short-term gains, but hold for the long term with a view to steady returns, and see themselves as professional managers of their properties. They are typically financially astute, mature, hold a range of investments and invest further to improve their properties, thereby enhancing yields.

According to the Association of Residential Letting Agents (ARLA), the average landlord is just over 50 years old, has been letting property for 11 years, holds an average of 8.1 properties and intends to retain their investment for over 17 years.

Separate Paragon research reaches similar conclusions on the average age of a landlord and their investment hold period, although the average number of properties stood at 12. Paragon's research, conducted in 2010, shows that over a fifth of landlords (21%) live in London, with a further 17% based in the wider South East. There are high concentrations of landlords in the Midlands, South West and North East.

They are financially sophisticated. Paragon's research showed landlords plan to make a range of investments during 2011. Along with residential property (25%), landlords plan to invest in equities (32%), bonds/gilts (12%), commodities (11%), precious metals (9%) and commercial property (7.1%), as well as holding cash savings (14%). This financial strength is reflected in gearing across landlords' portfolios – according to ARLA the average loan-to-value ratio across landlords' portfolios is 55%.

The role of 'novice' landlords in the PRS has been overstated. The Department for Communities and Local Government's Private Landlords Survey shows that three quarters of landlords are either individuals or couples, with nearly half having between six and 20 years' experience. According to the DCLG's survey, 23% of all landlords state that letting property is their main source of income. Paragon's research shows that landlords take a hands-on approach to their properties, with 44% not using the services of a letting or managing agent. The DCLG's figures show that 70% of landlords view property as an investment, with 12% viewing it as a future home for themselves or a relative.

*"According to the Association of Residential Letting Agents, the average landlord is just over 50 years old, has been letting property for 11 years, holds an average of 8.1 properties and intends to retain their investment for over 17 years"*

*"Landlords are usually equated with buy-to-let investors but as only a third of PRS properties have a buy-to-let mortgage, that assumption is too simplistic"*

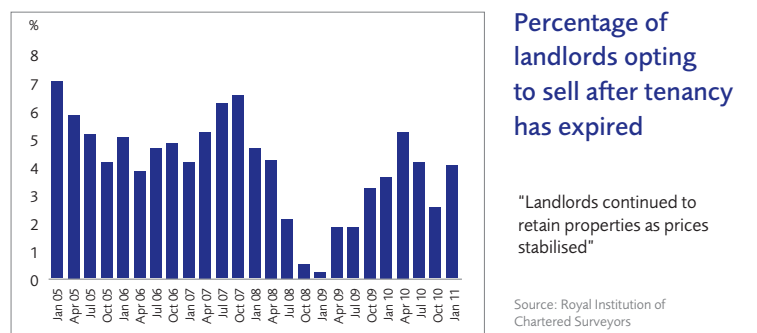
*"The role of 'novice' landlords in the PRS has been overstated. The DCLG's Private Landlords Survey shows that three quarters of landlords are either individuals or couples, with nearly half having between six and 20 years' experience"*

*"25% of landlords plan to purchase buy-to-let property during 2011 - which equates to approximately 250,000 landlords"*

However, there are difficulties in quantifying the number of landlords. For example, some only let their property for a short time, such as 'accidental landlords' - those homeowners who let their property because they are unable to sell - although this is only likely to make up a minority of landlords in the PRS. The DCLG estimates there are 1.2 million landlords operating in England, whilst market researchers Mintel put the figure at 1 million for the UK.

### Strong investor demand

In an environment of strong tenant demand, investor appetite remains positive. Landlords resisted the opportunity to dispose of stock during the recession and, although it can be argued that they did not want to sell in a falling market, they have continued to retain property as prices have stabilised. RICS' Residential Lettings Survey shows that the proportion of landlords opting to sell property at the expiry of a tenant lease was just 4.0% during Q4 2010.



Looking forward, there is also strong appetite to purchase. ARLA's Q4 2010 Residential Investment Review & Index showed a quarter of landlords said they planned to purchase buy-to-let property during 2011, compared to 7% who said they would sell. That equates to approximately 250,000 landlords looking to purchase based on Mintel's market figures.

Whilst it is clear that there is a dislocation between desire and ability to purchase, there are several factors underpinning landlords' desire to purchase.

**Tenant demand**

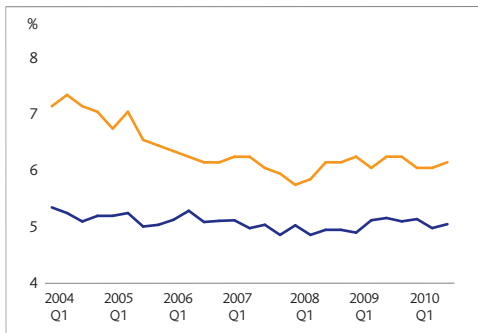
The UK is experiencing extremely strong levels of demand. However, this demand is growing in a period of constrained supply as landlords have been unable to expand their portfolios due to the credit crunch. Findaproperty's Rental Index highlighted the lowest number of rental properties available during Q3 2010 since July 2008, whilst RICS has recorded six successive quarters of falling new landlord instructions.

**Strong rental returns and yields**

Rents rose throughout 2010 as tenant demand exceeded supply. RICS' Residential Lettings Survey showed that the rate of rental growth during the fourth quarter was at an all time high, with 40% more surveyors reporting an increase in rents than a fall. Meanwhile, LSL Property Services' Buy-to-let Index showed that rents rose for 10 consecutive months during 2010. Looking forward, Paragon research shows that 41% of landlords plan to raise rents in 2011. Nearly a third of landlords (31%) plan to increase rents by up to 4%, with 10% aiming to increase the rent they charge tenants by between 4% and 8%. Strengthening rents against a flat housing market creates opportunities for yield growth. Yields have been consistent over the past two years, averaging 6% according to Paragon's statistics, but they are likely to rise if current market conditions continue.

*"Over the long term, house price movement will generally be positive and landlords are prepared to ride out short-term fluctuations in house price movements, as RICS figures testify"*

*"Looking forward, Paragon research shows that 41% of landlords plan to raise rents in 2011. Nearly a third of landlords (31%) plan to increase rents by up to 4% of the current value, with 10% aiming to increase the rent they charge tenants by between 4% and 8%"*



**Market rental yields**

— Paragon  
— ARLA

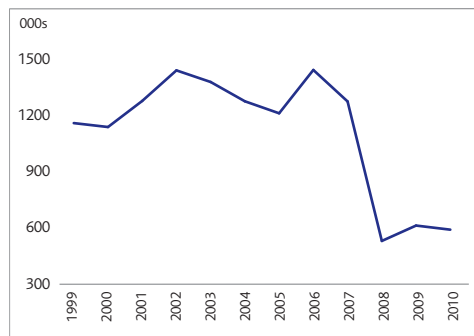
"Yields have been relatively stable for 3 years"

Source: Association of Residential Letting Agents

*"The lack of activity in the housing market makes it a buyers' market. The CML has forecast that the number of residential property transactions will be 860,000 in 2011, down on 2010 numbers"*

### Capital appreciation

Over the long term, house price movement has generally been positive and landlords are prepared to ride out short-term fluctuations in house price movements, as RICS' figures testify. According to the Nationwide's House Price Index, the average property value is now 3.2 times higher than it was when the index was first launched in 1991, whilst research by Lloyds Banking Group showed residential property was the second best performing asset class during the last decade, returning 198%.



### Approvals for house purchase

"House purchase approvals more than halved in 2008"

Source: Bank of England

### Buyers' housing market

The lack of activity in the housing market makes it a buyers' market. The CML has forecast that the number of residential property transactions will be 860,000 in 2011, down on 2010 numbers (890,000) and the same figure as 2009. Chain-free landlords are in a strong negotiating position when purchasing property and a flat housing market allows them to make considered purchases.

### Excellent credit quality

The buy-to-let arrears performance has outperformed the wider mortgage market for all but three quarters, suggesting that the underlying performance of buy-to-let investment is sound.

## Creating the right environment

The Government must facilitate a regulatory and economic environment that ensures a committed base of landlord investors and lenders.

### Regulation

Fostering a regulatory environment that encourages the continued participation of both residential property investors and lenders is vital. The UK has chosen to recognise that purchasing and financing Private Rented Sector (PRS) property is a commercial activity. The FSA proposed extending the scope of consumer-focused FSA mortgage regulation to buy-to-let in 2009, but following a consultation HM Treasury has not taken this forward.

A buy-to-let loan is commercial; it is the borrower's intent to let the property in which they are investing to generate a return and, in the long term, to sell it at a profit. Buy-to-let mortgages are secured on the residential asset and will in all cases have been taken out for business purposes. The nature of the liability means that if an individual is in default on a buy-to-let mortgage which eventually results in a loss to the lender, their other assets may also be at risk. This is identical to all commercial debt where a full personal guarantee is taken by the lender.

The PRS is heavily regulated and landlords have to comply with a wide array of rules governing the sector - over 50 Acts of Parliament and 70 sets of regulations according to the National Landlords Association (NLA). Early actions by Housing Minister Grant Shapps have been encouraging. Additional landlord regulations proposed by the previous Government have been removed, including a national landlord registration scheme, and the Government has also eased House in Multiple Occupation rules.

Grant Shapps said in June 2010:

*"With the vast majority of England's three million private tenants happy with the service they receive, I am satisfied that the current system strikes the right balance between the rights and responsibilities of tenants and landlords."*

Creating a fair and proportionate regulatory environment is critical to maintaining a committed base of professional private landlords. The Government's objectives of protecting tenants and creating healthy and diverse communities are laudable, but disproportionate regulation could cause landlords to withdraw from the PRS, choking supply as a result.

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## **Mortgage funding**

The closure of the wholesale funding markets was at the heart of the credit crunch, preventing businesses from securing funding. This has affected all sectors of the economy, from a consumer being unable to secure a personal loan, to a small business losing credit facilities and large corporations being unable to securitise or refinance debt. The markets closed in the third quarter of 2007 and remained stubbornly shut throughout 2008 and the first half of 2009.

Wholesale funding became a significant feature of the mortgage market after deregulation in the 1980s, but only experienced substantial growth at the turn of the century as more lenders launched Residential Mortgage Backed Securities (RMBS). Between 2000 and 2007, the total amount of outstanding RMBS and covered bonds rose from £3 billion to £257 billion, growing from 2.5% of mortgage stock to 21.5%. However, the level of public RMBS issuance fell dramatically after Q2 2007.

This fall disproportionately affected the non-deposit taking lenders which typically operated in specialist lending sectors of the mortgage market, such as buy-to-let, and relied on the wholesale market to finance their lending activity. This is particularly the case as they were excluded from the previous Government's various lending stimulus schemes. Specialist lenders' gross new lending volumes have fallen from 17.4% of total lending in 2006 to 5.5% in 2010.

However, some signs of improvement gradually began to emerge in the latter half of 2009 with a handful of successful RMBS issuances. This continued in 2010, with approximately £60 billion of primary issuance compared to £10.5 billion in 2009. Funding costs have improved over the course of these deals, although they are still higher than pre-credit crunch levels.

Returning securitisation to health is a necessity for a well-functioning and vibrant mortgage market that supports a diverse customer base – not just those with the largest deposits and flawless credit histories.

## Conclusion

Buy-to-let finance has been the catalyst for the revitalisation of the modern Private Rented Sector (PRS). Over the past 20 years, the sector has undergone considerable change and today provides good quality and affordable accommodation to millions of renters.

The PRS is the only growing housing tenure and is forecast to overtake social housing in the coming years. Privately renting is now seen as an active choice, not something that people are forced to do because they cannot get on the housing ladder. But the sector needs to grow, and requires buy-to-let finance to foster that growth.

The credit crunch that impacted the availability of finance in the sector is still here but its bite is softer. Buy-to-let begins 2011 with confidence – the sector has proved its resilience during an economic downturn and lenders are responding by expanding competition and choice.

*"The credit crunch that impacted the availability of finance in the sector is still here but its bite is softer. Buy-to-let begins 2011 with confidence – the sector has proved its resilience during an economic downturn and lenders are responding by expanding competition and choice"*

## About The Paragon Group of Companies

Paragon is the UK's leading independent specialist provider of finance to residential property investors and professional landlords.

Paragon launched its first buy-to-let mortgages in 1995 and has focused its business on professional landlords who have proven experience in purchasing and letting residential rental property. This focus is reflected in the excellent performance of the Group's buy-to-let mortgage assets and its reputation as a leading voice in the sector.

At the end of its last financial year, it had approximately £10 billion of assets under management and 40,000 landlord customers.

Paragon is proud to be a member of the Council of Mortgage Lenders, the Intermediary Mortgage Lenders Association, the Association of Residential Letting Agents' lenders panel, the National Landlords Association and the Finance & Leasing Association.

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