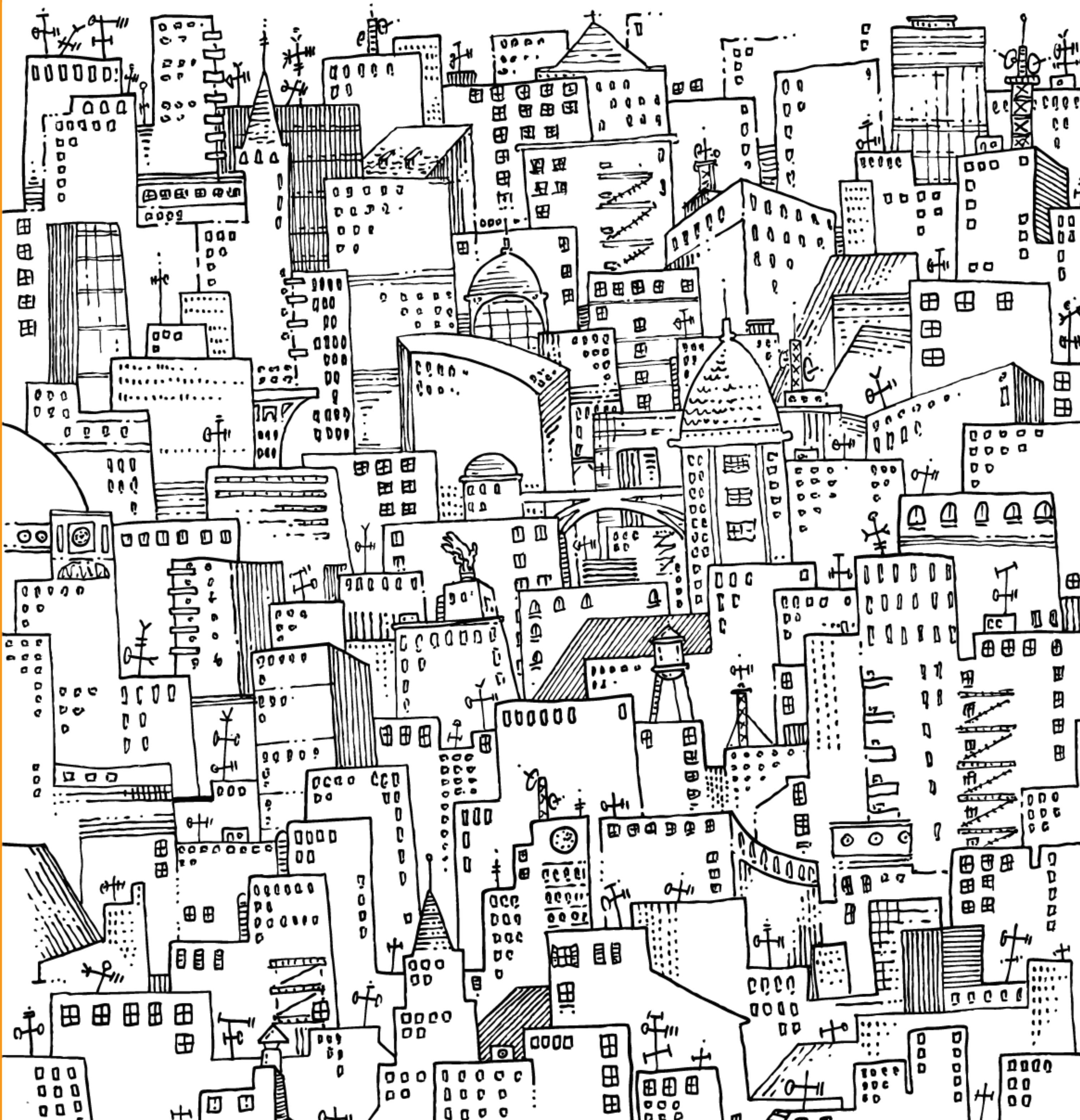
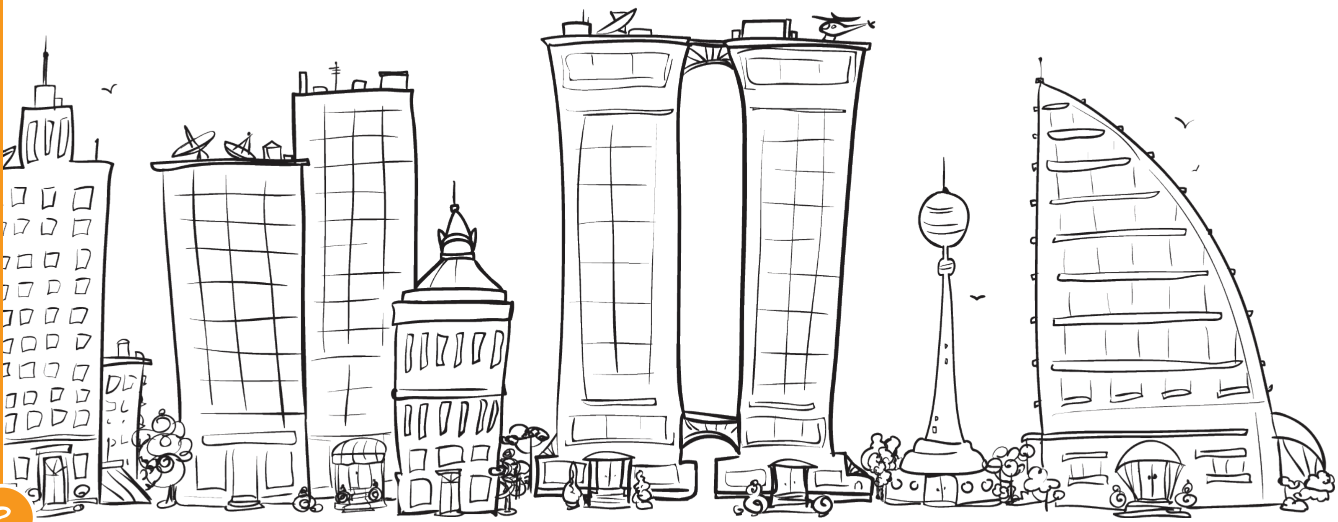
Today's Private Rented Sector

A home for one in five households





ABOUT US

PARAGON GROUP

Established in 1985, The Paragon Group of Companies PLC is an independent specialist provider of finance for people.

The Group is a FTSE 250 business, with more than 400,000 customer accounts and £10.5 billion of loan assets under management.

Paragon has three core business lines as a buy-to-let mortgage lender, debt purchaser and consumer bank.

PARAGON MORTGAGES

Paragon Mortgages caters primarily for professional landlords with larger portfolios who require bespoke services. We have particular expertise in this area of the market and in dealing with landlord customers who value a more individual approach.

Under our Mortgage Trust brand we provide buy-to-let mortgages for property investors with smaller portfolios who may not be full-time landlords. They will nevertheless have considered the business of being a landlord very carefully before acquiring buy-to-let property.

Paragon is proud to be a member of the Council of Mortgage Lenders, the Intermediary Mortgage Lenders Association, the National Landlords Association and the Finance & Leasing Association.

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INTRODUCTION

The housing market is changing. Once a market where growth in home-ownership seemed inevitable and getting a foot on the property ladder in your early twenties was accessible to all, today we are faced with a very different market and attitude towards the place we call home.

Over the last 25 years there has been a major shift in housing which has led to an increased bias to private renting both out of choice and out of need. These changes have their roots in the more tenure neutral housing policies that have been adopted since the 1980s, the impact of which has been amplified by the general undersupply of homes and the affordability challenge that would-be homebuyers face.

Paragon has been working with, and championing, the Private Rented Sector (PRS) for almost 20 years and in that time we have seen significant developments and improvements in the sector. In this report we take an in-depth look at the shape of today's market.

Today's PRS is the second largest housing tenure, accounting for one-in-five homes in England alone, overtaking the social rented sector for the first time since the 1960s. This represents a significant increase in the number of households living in private rented homes.

Along with looking at how the sector has grown and changed, we look at who is living there and who is providing the homes for the millions of private renting tenants in the market. Following the tax changes announced in the 2015 Summer Budget, we look at how private landlords and the wider market may be impacted.

One of the key factors that has facilitated growth in the PRS is the success of the buy-to-let mortgage market. The development of buy-to-let finance has enabled the sector to meet the increasing diversity of needs of a changing demographic.

When we last published our market report in 2013 we talked about the buy-to-let market being on the road to recovery following the financial crisis. This recovery is still underway with lending numbers still no better than they were ten years ago but it is clear that the recovery is gathering pace, with more lenders offering a greater range of products at more competitive prices than at any time since the crisis.

However, a strong PRS is only part of the solution to the problems we face in UK housing. We need to see chronic problems addressed, particularly the shortage of supply of affordable high quality housing across all tenures. Developing a long-term strategic plan to build more homes needs to be a top priority for policy makers from across the political spectrum if we are to deliver a housing market that is fit for purpose.

The PRS is a vital component of the solution in providing flexible access to housing at every level in the market, for those that do not want to buy and those who cannot. Buy-to-let plays an important part in this by financing good quality rented homes for landlords that are committed to improving standards in the sector and by expanding choice and competition.

John Heron
Director of Mortgages

EXECUTIVE SUMMARY

- Buy-to-let finance has been a factor that has allowed the Private Rented Sector (PRS) to expand to meet a rapid and sustained increase in demand for rented property over the last 25 years. In doing so it has helped improve standards and choice for tenants

- The PRS is now home to 4.9 million households in the UK, which has more than doubled since 2001 and is now the second largest housing tenure

- As the PRS has grown, the decline in the social rented sector has been significant, falling by one million homes between 1991 and 2012. The decline in owner-occupation is more marked still, having peaked in 2002 at 69.2% households, it is now 64.2%

- The perception of renting is changing. Whilst the PRS was once regarded as the tenure of last resort, it is now increasingly popular with young professionals, couples and families. The flexibility of the sector is being recognised by a larger and more varied demographic of people

- First-time buyer loan numbers, having slumped to 192,300 during 2008 at the height of the financial crisis from 592,400 in 1999, have started to recover and in 2014 lending volumes increased by 15.4%. Arguably, this area of the market may never return to levels seen during the 1990s and early 2000s, as many people continue to be constrained by weak affordability and the need to save for a deposit, factors reinforced by macro-prudential and conduct of business regulation

- Demand for privately rented property is growing. DCLG figures show that in 2002 there were 2,512,000 homes in the PRS, which increased by 96% to 4,920,000 by 2012. Over the same time period social housing has declined by more than 350,000 homes

- As the number of people living in the UK increases – the population is expected to grow to 71 million by 2030 according to Office of National Statistics (ONS) data – housing supply is failing to keep pace. Government figures show in the year 2013-2014 house starts totalled 160,250 and 140,930 were completed

- In the last two years there has been a steady improvement in buy-to-let business volumes - however, we are still only operating at the same level of lending as ten years ago. Council of Mortgage Lenders (CML) data shows that in 2014 buy-to-let lending totalled £27.4 billion, a 32.4% increase on the previous year. This equated to 197,000 loans – whilst a 22.9% increase on 2013, this is still a 42.9% decrease on the volumes seen in 2007

EXECUTIVE SUMMARY continued

- There has also been a marked improvement in the number of buy-to-let products available to landlords. Having slumped to below 200 in early 2011, we have seen a recovery in the number of products available. In July 2015 there were 941 live products

- Demand from tenants continues to remain high. In the second quarter of 2015 40% of landlords surveyed by Paragon said demand had increased. This is an ongoing trend with landlords' perception of demand continuing to be that it is either remaining stable or is increasing

“The PRS is a vital component of the solution in providing flexible access to housing at every level in the market, for those that do not want to buy and those who cannot.”

The PRS – second largest housing tenure

TODAY'S PRIVATE RENTED SECTOR

The Private Rented Sector (PRS) has grown considerably in the last ten years, to overtake social housing for the first time since the 1960s. Factors driving this growth are varied. One main factor that we have seen, for the first time in decades, is a significant shift in the perception of private renting.

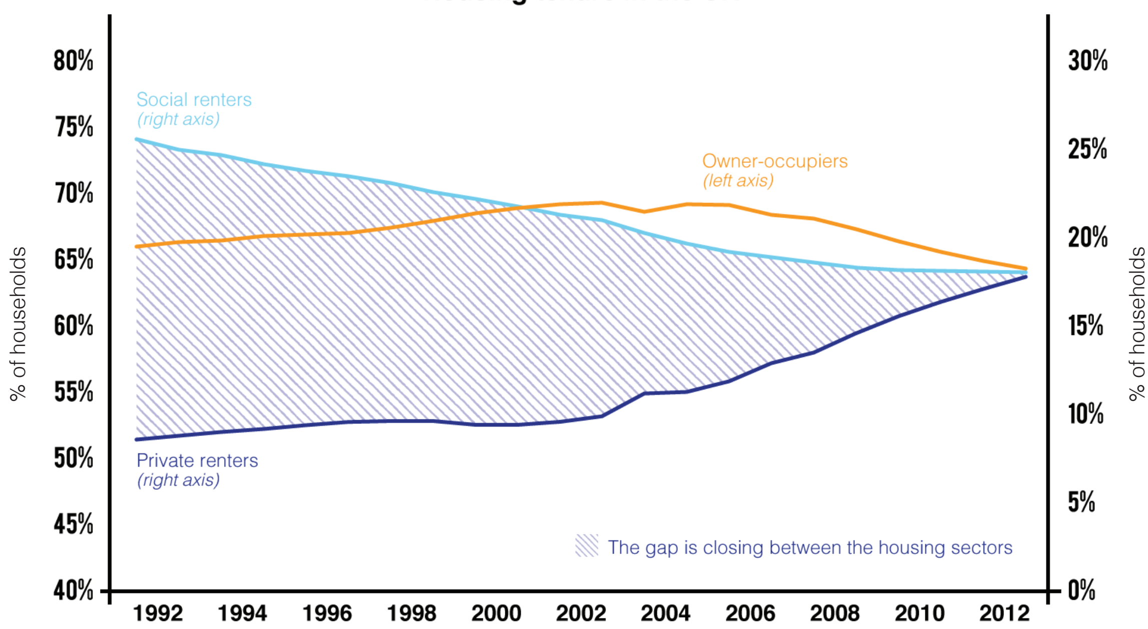
Once considered a tenure of last resort, dominated by students and younger generations, we are now seeing a more diverse tenant population. The sector does continue to be popular with those in higher education and young professionals, but it is also now a sector with more families and older generations too.

DCLG figures show that some 4.9 million households now call the PRS home. This figure has more than doubled since 2001. At the same time, the number of households living in the social rented sector has declined by more than 350,000. This has inevitably put pressure on the PRS as more people are turning to the sector for their housing needs. Owner-occupation levels, whilst experiencing some improvement in the number of people purchasing their own home following the financial crisis, are not yet anywhere near what they once were.

Today's owner-occupied market accounts for 64.2% of all housing: 5% lower than in 2001 and similar to levels seen back in the early 1990s (66.0% in 1991). Whilst there has been some recent improvement in people being able to purchase their own home, it is clear that we have started to see a step-change in the housing market driven by more than just the ability to buy a home.

In this report we look at the factors which have influenced the PRS growth and the impact this growth is having.

Housing tenure in the UK



Source: Department of Communities and Local Government

What is driving growth in the PRS?

SLOW-DOWN IN OWNER-OCCUPATION

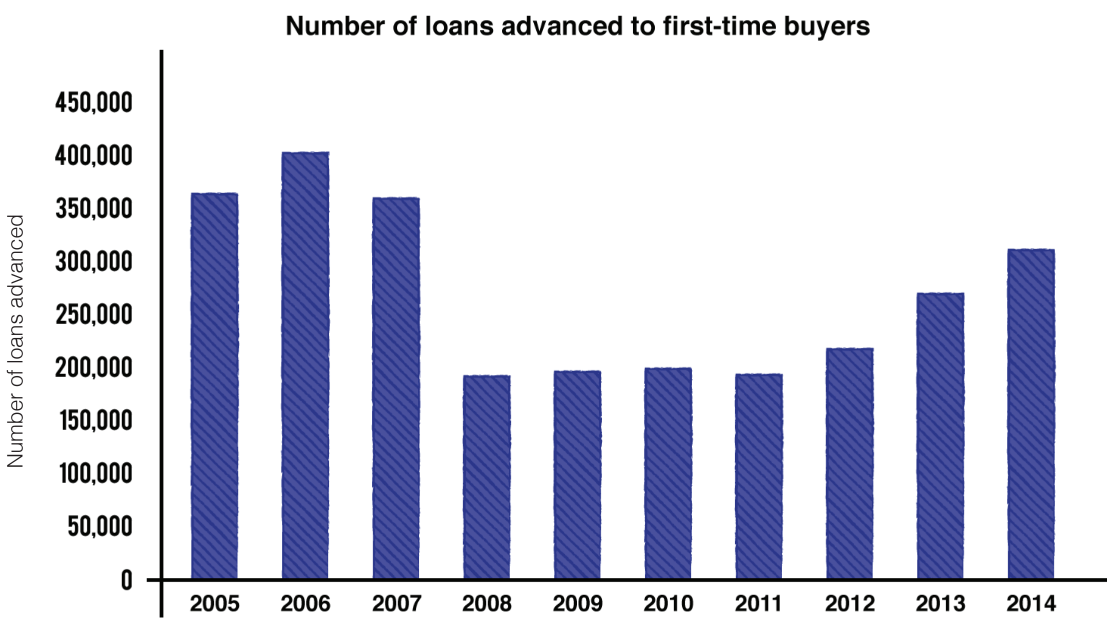
The owner-occupied market has unarguably improved since the financial crisis. Council of Mortgage Lenders (CML) data shows that in 2006 there were 1,114,800 loans originated to home-owners, but by 2011 this had dropped significantly to 509,400.

During 2013 and 2014 the number of loans for home-owners started to improve and at the end of last year data shows that 676,900 loans were made. However, whilst numbers have started to recover we are still a long way off the lending numbers associated with pre-crisis times.

First-time buyers are the sector of the home-owner market hit hardest by the financial crisis. First-time buyers may continue to find it challenging to source a mortgage following the implementation of the Mortgage Market Review (MMR), although it will be some time still until we can reliably asses the level of the impact.

CML data shows that in 2014 the number of gross advances to first-time buyers totalled 311,500. This is a 15.4% increase on the number of loans advanced in 2013 and a notable rise on 2011 lending when loans totalled 193,600.

The implementation of MMR has meant all home buyers are subject to a more rigorous mortgage application process in general and a challenging affordability assessment in particular. Whilst this will ensure a more sustainable market it may also lead to less choice and less innovation.



Source: Council of Mortgage Lenders

POPULATION AND HOUSE BUILDING

The UK's population has also grown further causing more strain on housing stock. Data from the Office of National Statistics (ONS) shows that the population of the UK in 2013 was 64.1 million. This is forecast to grow to 67.1 million in 2020 and 71.0 million in 2030.

Government household forecasts show by 2020 there could be 28.8 million households in the UK and by 2030, 31.2 million. House building at present is simply not keeping pace.

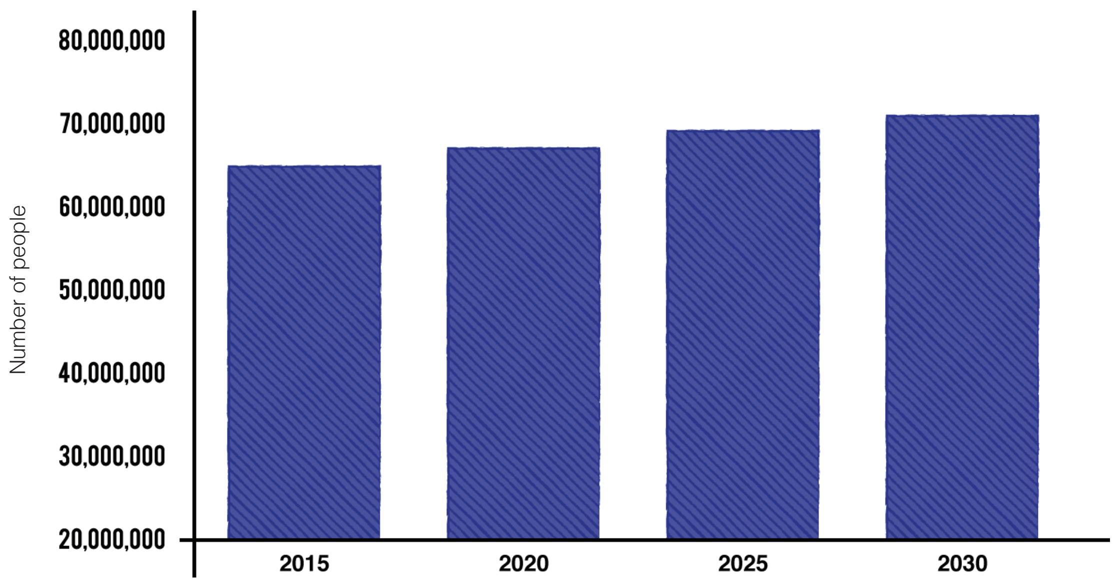
As one of the areas hardest hit by the financial crisis, the house building industry has been slow to recover. Official figures show in 2013-2014 there were 160,250 new homes started in the UK, up from 127,660 in 2012-2013. In terms of completions, last year there were 140,930 homes completed, an increase of only 5,420 new homes in 12 months.

Whilst there have been marginal increases in the number of new homes being completed, building activity is still not at a level that will meet demand and need as the UK's population grows.

It is estimated that, to meet this rise in demand, a 20% increase is needed in projected new housing, which is around 240,000 to 250,000 new homes per year (ref: Town and Country Planning Association).

Going forward, the house building industry will need a supportive regulatory and policy environment to enable a full recovery.

Population growth forecast in the UK



Source: Office for National Statistics / Department of Communities and Local Government

NET MIGRATION

Migration to the UK continues to be a key contributing factor in population growth and in turn, the increased pressure on the PRS.

Net long-term migration for the year ending September 2014 was 298,000, up significantly from 210,000 in the previous 12 months.

Data shows that 624,000 people immigrated to the UK in the year ending September 2014, an increase from 530,000 in the previous year.

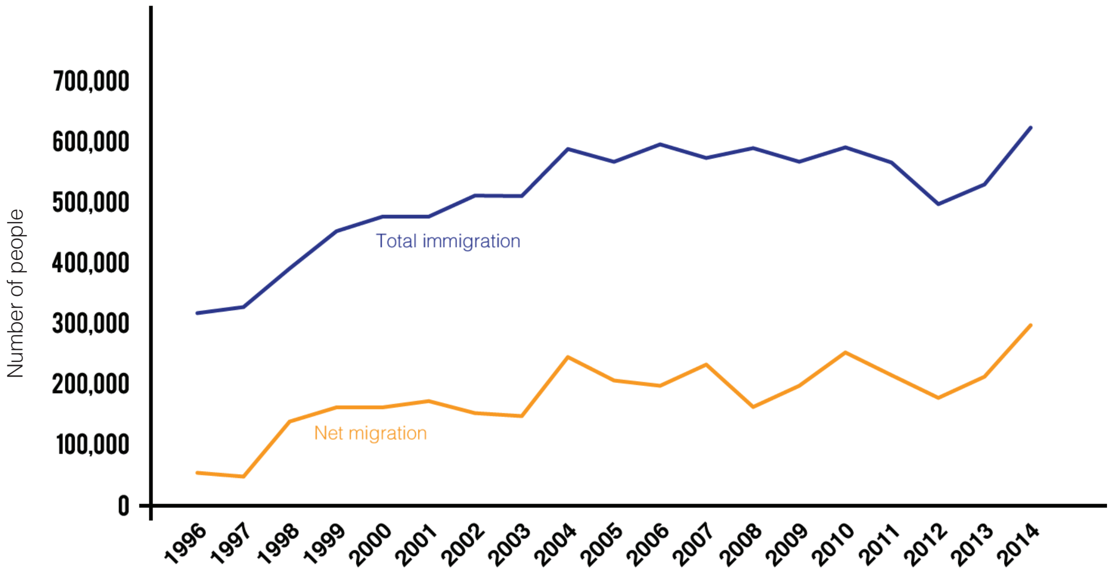
In 2014 the most common reason for immigration was economic-related reasons, with 271,000 people giving this as their reason, up from 217,000 in 2013.

According to a report by Oxford University's Migration Observatory, recent migrants (those living in the UK for five years or less) are more than twice as likely to be renters than other migrants (those living in the UK for more than five years) – 80% were living in the PRS in 2013.

The report also shows that the foreign-born population has significantly lower home ownership rates. Just 43% were homeowners in 2013 compared with UK-born at 69%.

With the rate of immigration maintaining its momentum, we will continue to see an increase in people living in the PRS.

Net migration continues to grow



Source: Office for National Statistics

THE STUDENT POPULATION

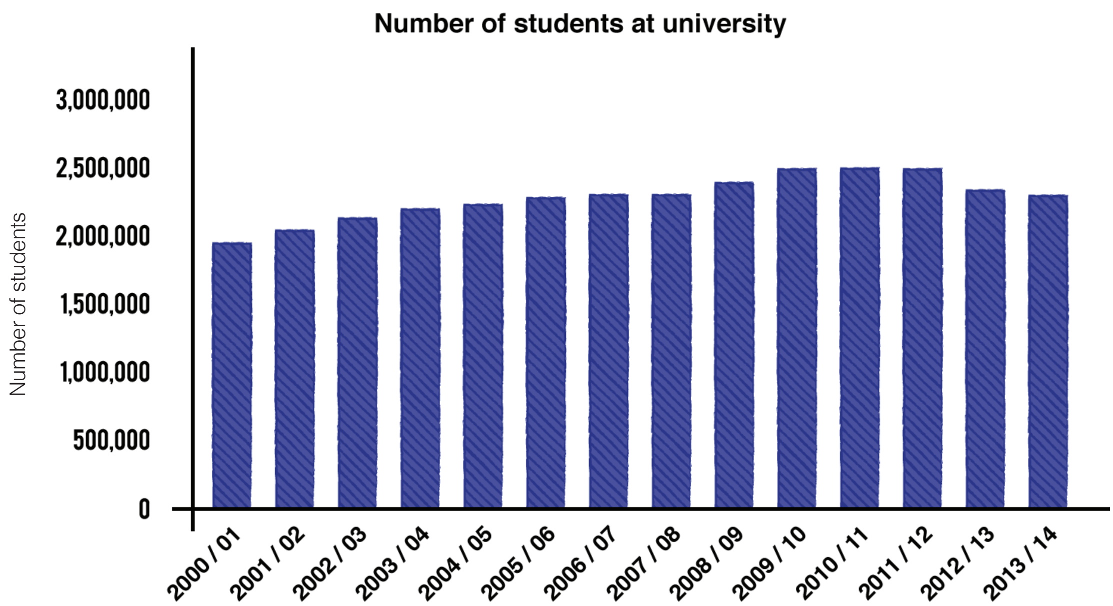
The student market is a significant component of the PRS and students have long been associated with the sector. Traditionally, students would live in the sector whilst they completed their studies before returning home. English Housing Survey data for 2013/2014 shows 5.4% of all households in England's PRS were tenants in full-time education*.

However, with more and more young people over the past ten years entering higher education, there has been steady and increasing pressure on private rented stock.

In January 2015, UCAS – the university applications service – reported they had received 592,290 applications for higher education courses, which is a 2% increase on the same time period last year.

Students continue to rely on the PRS and form a sizable proportion of the overall market, both whilst studying and also following graduation. Research by BDRC Continental, commissioned by Paragon, shows in Q2 2015 14% of landlords currently let to students.

Graduates often remain living in the sector as they need to be more mobile for work, they have accumulated debt whilst studying and they value the flexibility the sector offers, allowing them to be transient and continue living with friends.



Source: Higher Education Statistics Agency

*The English Survey defines those in full-time education as "education undertaken in pursuit of a course, where an average of more than 12 hours per week is spent during term-time"

TENANT DEMAND

Demand from tenants for private rented accommodation has remained relatively stable. With more pressure on first-time buyers to save the larger deposit they need in today's market and subject to more stringent checks since the implementation of MMR, more people from this market have entered the PRS or have been staying in the sector for longer.

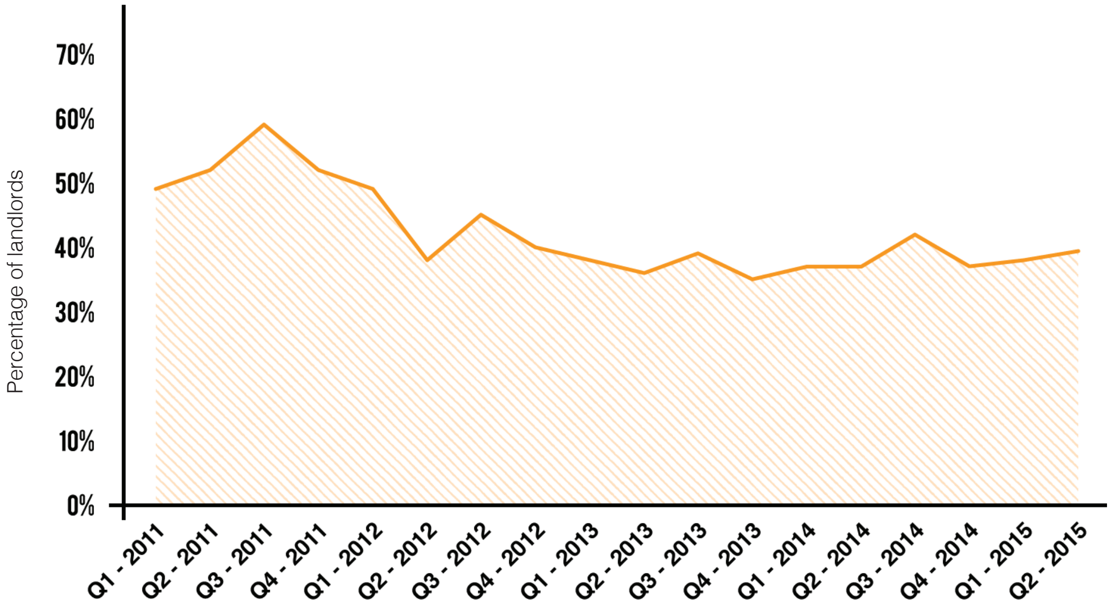
There has also been an increase in families living in the PRS, as well as the continuing popularity for more transient segments of the market choosing to live in the sector for longer periods. Landlords continue to see a high level of tenant demand and a decrease in void periods (the time a property is empty between tenancies).

Paragon research, carried out by independent market specialists BDRC Continental, shows that there has been a sustained proportion of landlords reporting steady tenant demand since 2011.

In the first quarter of 2011, 49% of landlords reported tenant demand was increasing, and during Q3 more than half (59%) said demand had increased.

In 2014 tenant demand appeared to stabilise with, on average, a third of landlords (38%) reporting an increase in demand from tenants. In the second quarter of 2015, again, 40% of landlords described tenant demand as increasing and 34% said they had seen no change.

Percentage of landlords describing tenant demand as stable



Source: BDRC Continental

DECLINE IN THE SOCIAL HOUSING SECTOR

Social rented housing stock declined considerably from the early 90s to the mid-2000s. In 1991 there were six million homes provided by the UK government and by 2000 this had fallen to 5.5 million. In 2006 the number of properties in the sector dropped to its lowest level at five million homes. There has been however, some recovery in the sector, with the number of properties totalling just over five million in 2012.

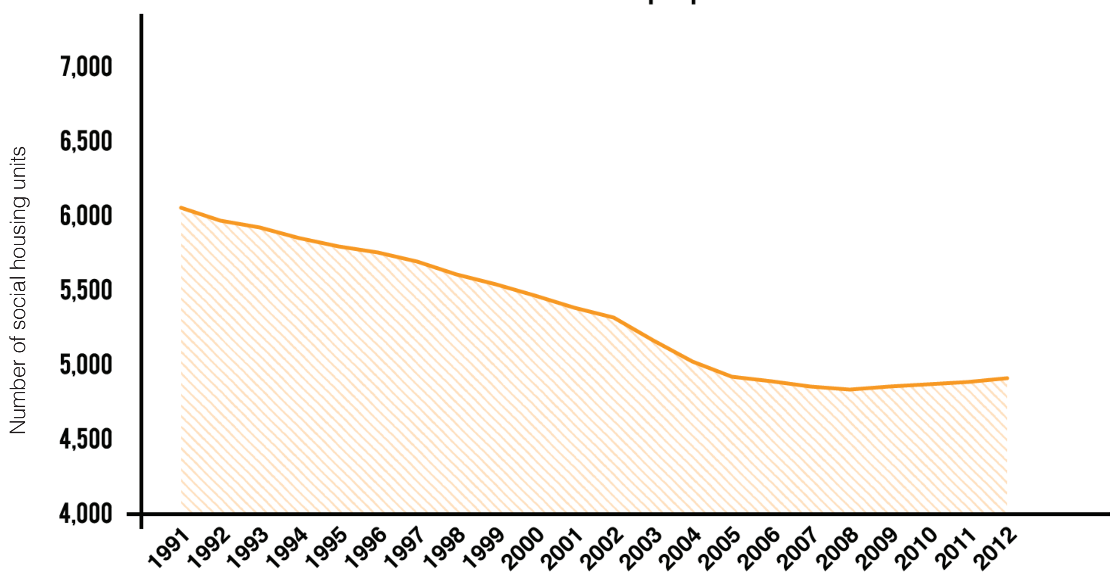
Looking back to 1919, social renting increased following the introduction of the Housing, Town and Planning Act, which obligated Local Authorities to provide housing for those in need. By 1981, 32.7% of all households were social rented homes before falling again after the introduction of 'Right to Buy' in 1980.

Whilst financially it has been difficult for Housing Associations during the credit crunch years, there has been some improvement in new house building starts. In England in 2013/2014 there were 25,070 new starts, a 26% increase on 2012/2013 activity.

Recovery in the Local Authority area of the sector has been much slower. In 2013/2014 DCLG data shows just 2,190 new social homes were started by Local Authorities in England.

During the same time period, 11,261 homes were sold by the Government under the Right to Buy scheme. This was more than a 50% increase on 2012/2013 and already in the first three quarters of 2014/2015, a further 8,980 homes have been sold. These figures demonstrate the widening gap in the supply and demand for social rented homes.

The number of social rented properties decline



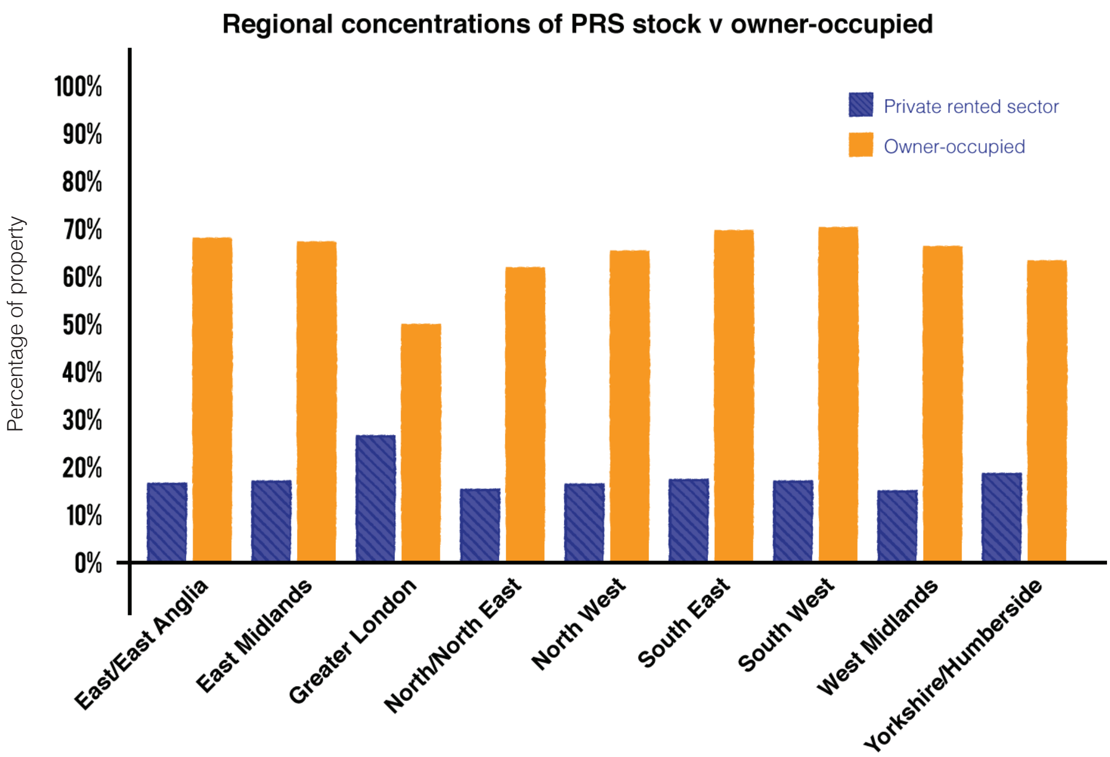
Source: Department of Communities and Local Government

REGIONAL DISTRIBUTION

The regional distribution of PRS property and tenant demand is weighted heavily towards urban centres, with higher proportions of tenants living in large towns and cities.

London is a particular focus, with 27% of housing stock in the PRS and 50% in the owner-occupied sector. This is in contrast to the rest of the country which has an average of 17% of housing stock in the PRS and 66% in the owner-occupied sector.

Landlords will look to make investments in areas where tenant demand is highest, so it is inevitable some cities, and even regions, will have higher concentrations.



Source: Department of Communities and Local Government / Paragon

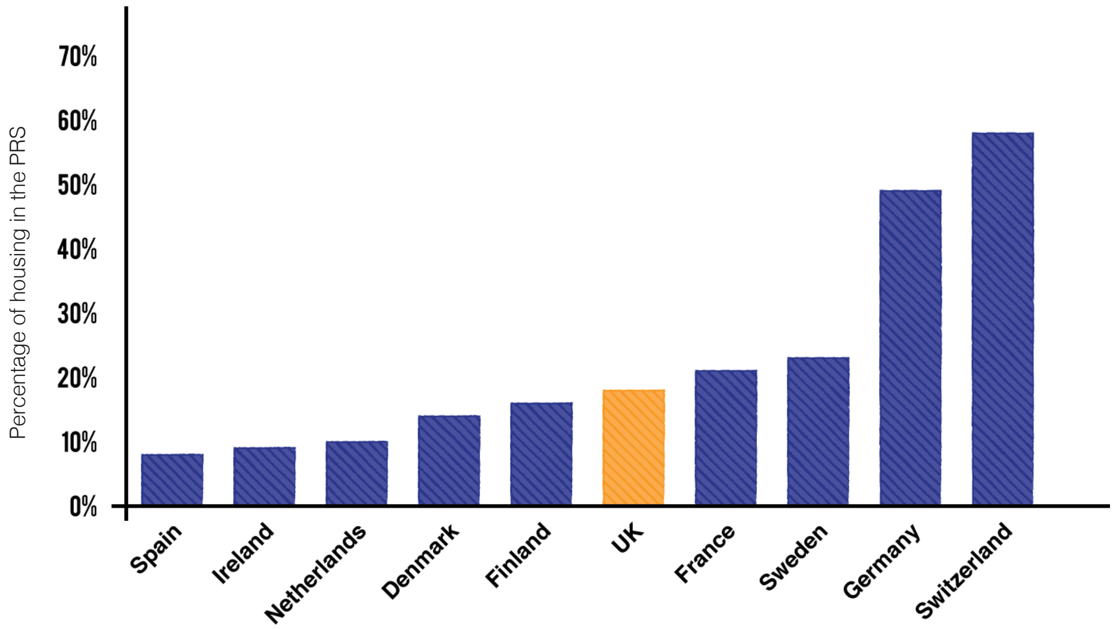
INTERNATIONAL RENTAL MARKETS COMPARISON

Compared with rental markets around the world, the UK's market, despite its expansion, is still relatively small.

A report by the University of Cambridge compiled in 2012, gives an overview of the size of other private rented sectors in the European Union countries.

Whilst the UK's PRS accounts for 18% of all housing, Germany and Switzerland are more than double the size at 49% (2006) and 58% (2012) respectively. However, the UK's PRS is considerably bigger than those in Spain (8% - 2008) and The Netherlands (10% - 2009). It is also worth noting that whilst the UK might have a smaller PRS by comparison, it is growing. In Germany there has been some evidence of the rental market contracting in certain cities, such as Berlin, where homeownership is becoming more attractive.

The UK's PRS is small compared with other European countries



Source: Cambridge University report 'The Private Rented Sector in the new century'

“Typically, landlords invest in properties and areas that have strong demand and are close to urban centres with high levels of employment, good transport links, centres of education and other key public services.”

Who are the UK's landlords?

There are approximately 1.4 million landlords (HMRC data) operating in the UK. Landlords are usually associated with buy-to-let investors, however only around a third of privately rented properties have a buy-to-let mortgage, so this assumption is too simplistic. A report released in 2014 by the Intermediary Mortgage Lenders Association (IMLA) found that only 420,000 of the additional 1.3 million properties in the PRS between 2007 and 2012 were financed by buy-to-let mortgages.

What we do know about landlords is they are financially astute individuals, investing their capital for long-term not short-term gains. With the various costs associated with purchasing property, it would simply not be viable to invest for short-term periods. The Association of Residential Letting Agents (ARLA) data shows landlords, on average, expect to retain their property investment for 20 years.

ARLA data also shows that the average landlord is 56.3 years old, has been letting property for 15.6 years and has 8.6 properties in their portfolio.

Landlords do fall into two distinct groups though – those for whom being a landlord is a full-time occupation, who typically own a larger portfolio, and those who hold a small number of properties, often just one, as a means of augmenting other savings and investments.

Large-scale landlords have extensive portfolios, often consisting of several property types in and around the same geographical area. These types of landlords often invest in more bespoke and complex rental properties such as Houses of Multiple Occupancy (HMOs) and multi-unit blocks. The running of their rental portfolio will also often be their main source of income.

Private investor landlords tend to have between one and five properties in their rental portfolios and their buy-to-let activities will act as a supplement to their regular income. These landlords tend to purchase single, self-contained rental properties, such as flats or terraced houses in popular student rental markets.

The Department for Communities and Local Government's (DCLG) Private Landlords Survey 2010, shows that 89% of landlords are individuals, 49% have between four and ten years' experience and 18% between 11 and 20 years. The survey also reveals that 81% of landlords own one property and 16% have between two and four. So whilst the larger, professional landlords operating in the market are fewer, they have larger portfolios. The majority of landlords though, are smaller-scale, property investors.

Landlords were undoubtedly affected by the financial crisis, with difficulties in sourcing the appropriate finance due to the constraints that buy-to-let lenders faced during the period.

Our research, commissioned by BDRC Continental, shows that during the height of the credit crunch in 2008, landlord confidence in the prospects for the PRS dropped to an all-time low. At the start of 2007 (Q1) 72% of landlords rated prospects for the sector as good or very good. By the end of the year, this had fallen to 57% and by mid-2008 it had dropped a further 9% to 48%.

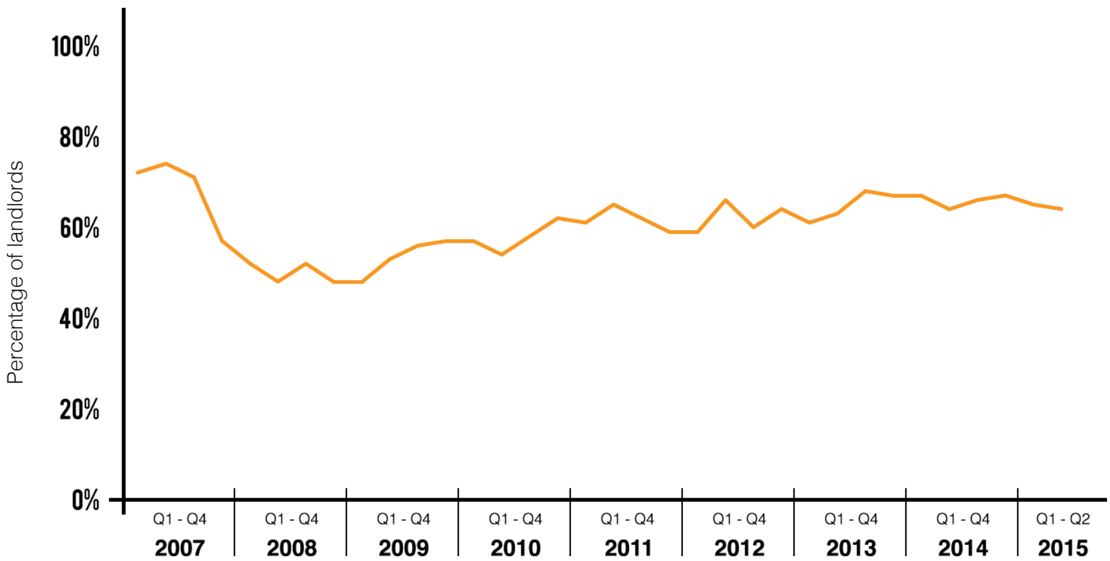
Confidence started to recover by late 2009 and early 2010. Since the start of 2010 the percentage of landlords feeling positive about the PRS has not fallen below 60% and in 2014 remained stable at an average of 66%.

There has been a steady recovery in the landlord sector and in 2015 our research also shows that 29% of landlords are planning to make further investments in their rental portfolios this year. Further investment in the PRS is essential in meeting the level of demand from tenants. This level of investment however, will not be met unless Government and businesses work together to encourage investment from institutional investors. A report issued earlier this year by the CBI looks at the wider housing market and the growing need for investment in the PRS, namely by institutional investors. It states: “traditional lending to buy-to-let landlords will remain vital but the need for institutional investment to help increase the flow of supply to meet rising demand is more important than ever.”

The report also features an estimate of the level of investment required to meet demand for private rented property, stating it is in the region of £57 billion a year by 2016, if the rate of growth in the sector mirrors the five years to 2010.

Private landlords bring a huge amount of expertise to the sector, not least the local market knowledge they have, which is why they will continue to be the mainstay of the sector.

Percentage of landlords who felt confident about prospects for their properties



Source: BDRC Continental

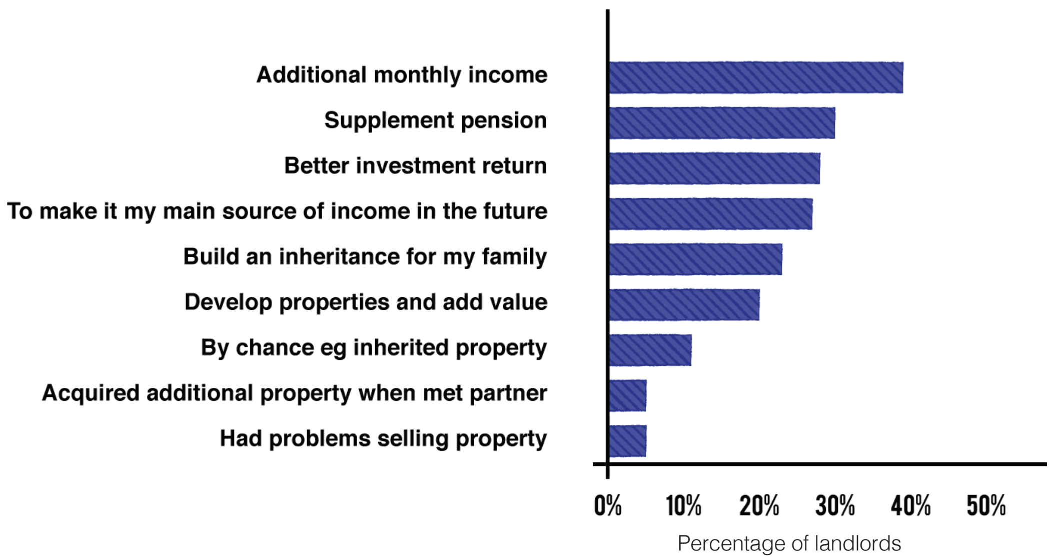
LANDLORD MOTIVATION

There are two main drivers for landlords investing in buy-to-let property – capital appreciation and rental yield. The overwhelming majority of landlords are financially aware and when planning to invest in rental property, are planning for the long-term. Investing in buy-to-let is a business decision, and buying and letting in the short-term is not a viable option due to the costs associated with buying and selling property and property management.

Research commissioned by Paragon in 2014 showed 39% of landlords first became involved with letting property as an additional source of income and 30% to supplement their pension.

More than a quarter (28%) became a landlord because investing in property presented a better return than the alternatives, and for 27%, the objective is for it to be their main source of income in the future.

Landlords' motivations for investing in buy-to-let



Source: BDRC Continental

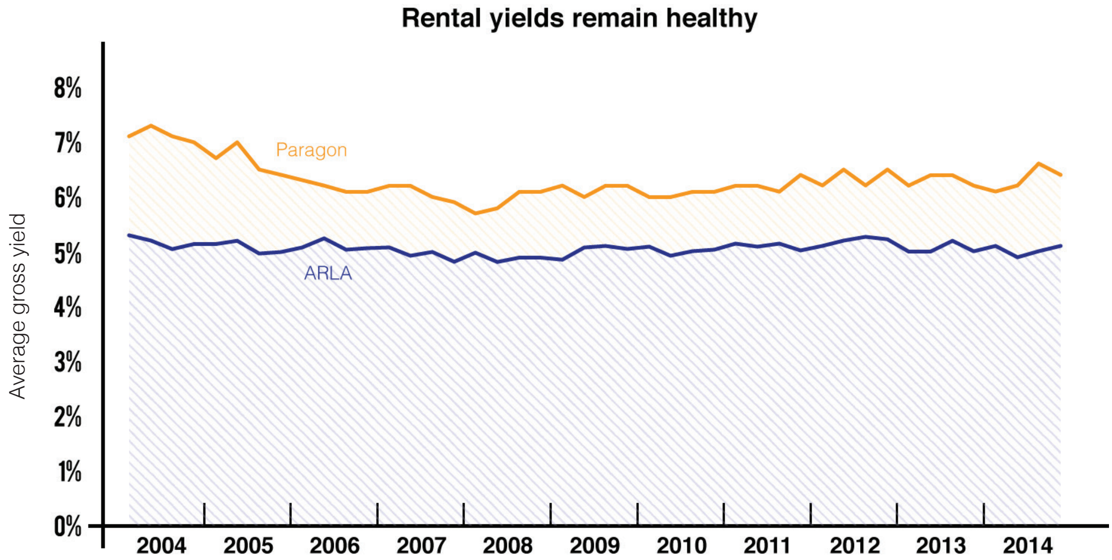
RENTAL YIELDS

Gross rental yields (the annual rental income divided by the property value) are a key measure for landlords, and for the most part have remained stable for the past three years.

Data from LSL Property Services shows the average yield in July 2015 for rental property in England and Wales was 5.2%. There has been little movement since the previous month and in July 2014 the average yield was 5.0%.

The stability seen in yields appears to be a long-term trend with LSL data showing the average remaining between 5.0% and 5.4% since the second quarter of 2011.

Paragon's landlords have reported a consistent average yield of 6.3% for the past two years and looking back over time, the average has been above 6% since 2008.



Source: Association of Residential Letting Agents / Paragon

PURCHASING BEHAVIOUR

Typically, landlords invest in properties and areas with strong tenant demand close to urban centres with high levels of employment, good transport links, centres of education and other key public services.

According to Paragon's research, during the next 12 months almost a third of landlords (29%) plan to buy further buy-to-let property. During 2014 the same survey findings revealed 26% of landlords purchased property during the past 12 months.

Paragon's PRS Trends survey of landlord customers revealed that in the second quarter of 2015, of those landlords looking to purchase new buy-to-let property, 35% are planning to buy terraced houses and 35% semi-detached houses. Just over a fifth (22%) said they were planning to invest in more specialist rental properties – HMOs and multi-unit blocks. What these findings demonstrate is that there is certainly a preference to invest in more flexible rental propositions, as both terraced and semi-detached houses can work for a variety of tenant types – couples, families or friends sharing. DCLG data shows 34% of tenants living in England's PRS live in terraced houses.

TAX CHANGES FOR LANDLORDS

In the 2015 Summer Budget the Chancellor announced changes in the way that rental income on residential property would be taxed going forward, particularly in the level of tax relief available on the costs of finance.

Typically, landlords who are effectively running an SME letting business, pay tax on the rent they earn net of allowable expenses. Such expenses include: the cost of finance, repairs, maintenance and other running costs. In this respect they are no different to other small businesses.

However, this will now change as the Chancellor announced in his Budget speech. Landlords will no longer be able to deduct all of the costs associated with their mortgage finance and will instead be limited to tax relief at the basic rate of 20%. The changes will be phased in over four years from April 2017.

It is too early to say what the full impact of these changes will be, but it is likely that they will result in some landlords limiting further investment in property and they may well deter new landlords from entering the market. In a market that continues to be characterised by strong rental demand, it is also possible that landlords will look to recoup some of their increase in costs by increasing rent to tenants.

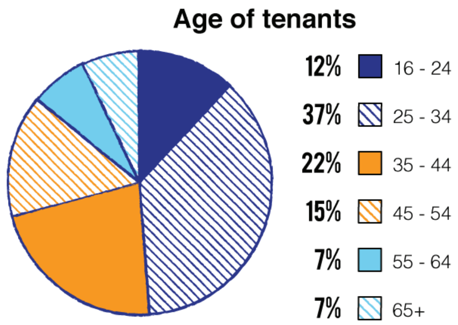
Who are the PRS tenants?

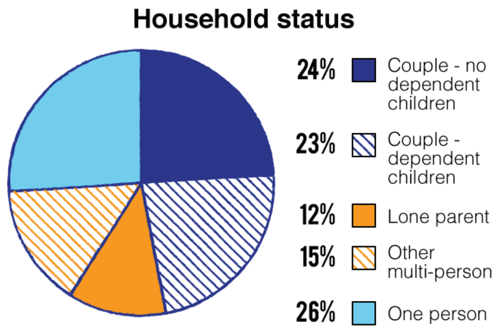
The Private Rented Sector (PRS) is home to an increasingly diverse tenant profile. The sector has traditionally been regarded as one for young people and especially students. However, whilst the sector is of course still popular with these sub-sections, there has been a definite shift in tenant dynamics.

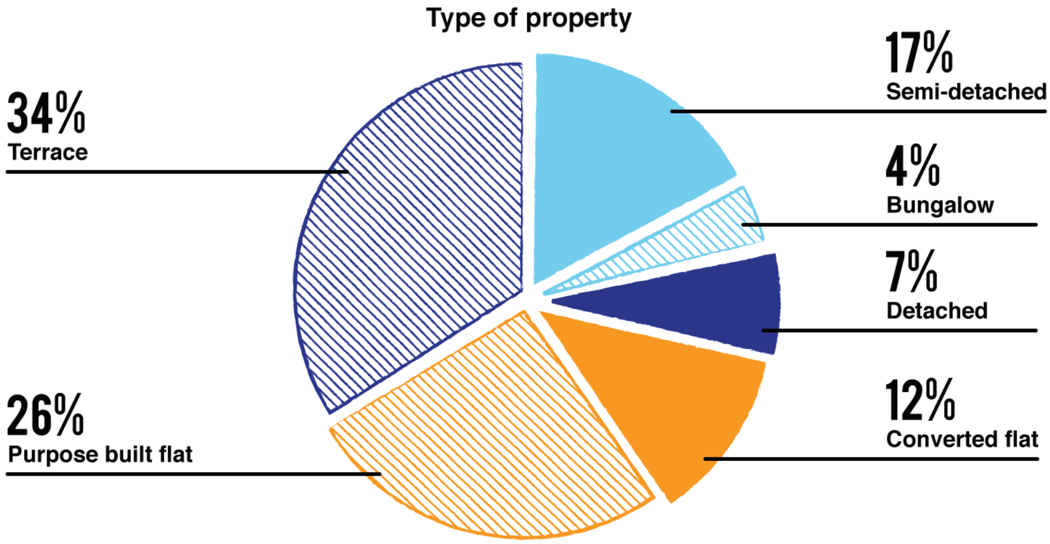
Government data shows 37% of tenants living in the PRS are aged between 25 and 34, whilst 22% are aged between 35 and 44 years. Looking at the split in terms of household status, 24% of tenants are couples with no children, whilst a third (35%) are families – either couples with dependent children or lone parents. The percentage of families living in the PRS has increased steadily in recent years as financial constraints have impacted on the ability to source a mortgage and purchase a property.

The findings of the 2013/2014 English Housing Survey show an increase on 2012/2013 percentages of families (couples with dependent children and lone parents) living in the PRS from 33% to 35%. The percentage of families living in the PRS has now also overtaken the number of families living in social rented homes – 33% of social tenants were families in 2013/2014.

The most typical property type for PRS tenants to live in are terraced houses, followed by purpose built flats and semi-detached houses and there has been little movement here.







Source: Department of Communities and Local Government

"THE INTRODUCTION OF BUY-TO-LET MORTGAGES IN 1995 WAS AN IMPORTANT DRIVER OF GROWTH IN THE PRS."

UK buy-to-let market

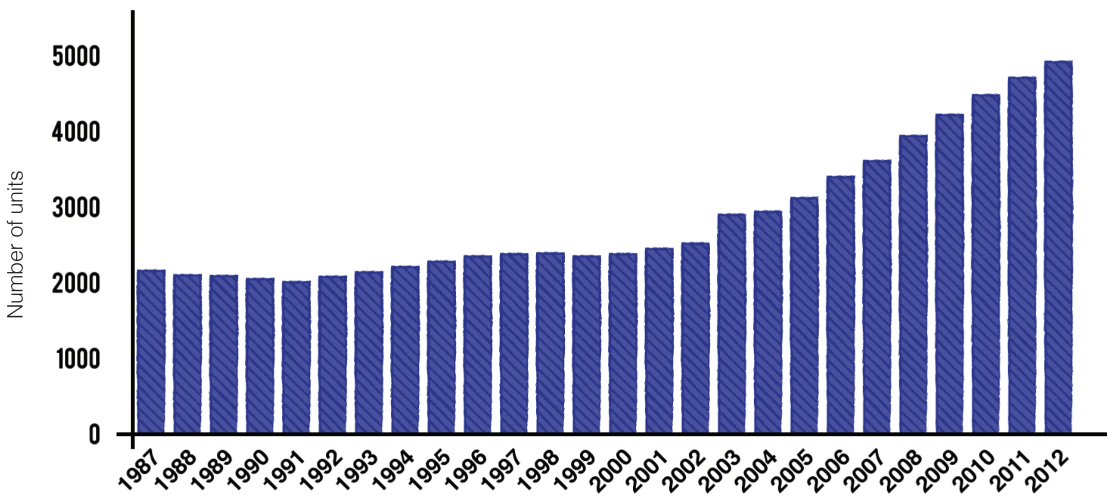
BUY-TO-LET AND ITS SUPPORT OF THE PRS

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 sector 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, impacts of the regulatory regime and the increasing role of the State as a landlord through Local Authority housing.

The PRS was inhibited by a restrictive regulatory regime that discouraged 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 right to vacant possession. However, the introduction of buy-to-let mortgages in 1995 was an important driver of growth in the sector. It generated a significant injection of fresh finance into the PRS by creating a product more tailored to landlords' requirements than traditional commercial finance or residential mortgages.

Between 1991 and 2012, the number of households in the PRS more than doubled from 2.0 million to 4.9 million. This is the largest single increase across each housing tenure type. Compared with the owner-occupied sector this was a more substantial increase, as this area of the housing market only grew from 15.5 million dwellings in 1991 to 17.8 million in 2012.

PRS stock has increased consistently since 1999



Source: Department of Communities and Local Government / Council of Mortgage Lenders

Looking at buy-to-let lending over time, there were a total of 48,000 advances made in 2000, whereas today, volumes have increased more than four times to 197,700 in 2014, at a value of £27.4 billion (2000: £3.9 billion). However, it is worth reiterating here that the market, whilst vastly improved since the financial crisis, is still operating at lending levels last seen ten years ago.

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 Housing Survey, the number of homes in the PRS classed as 'non-decent' fell from 47% of all stock in 2006 to 30% by 2013/2014. This is a marked improvement and is reflected in tenants' views of their homes. Government figures show that 84% of private renters are either 'very satisfied' or 'satisfied' with their home. The PRS also has proportionately more dwellings in the energy efficiency bands A - C than the owner-occupied sector.

A MARKET RECOVERING

The buy-to-let market has returned to healthy levels of business following a sharp decline between 2008 and 2010. Whilst the market is not seeing the volumes of the mid-2000s, there has been steady and positive growth following the financial crisis.

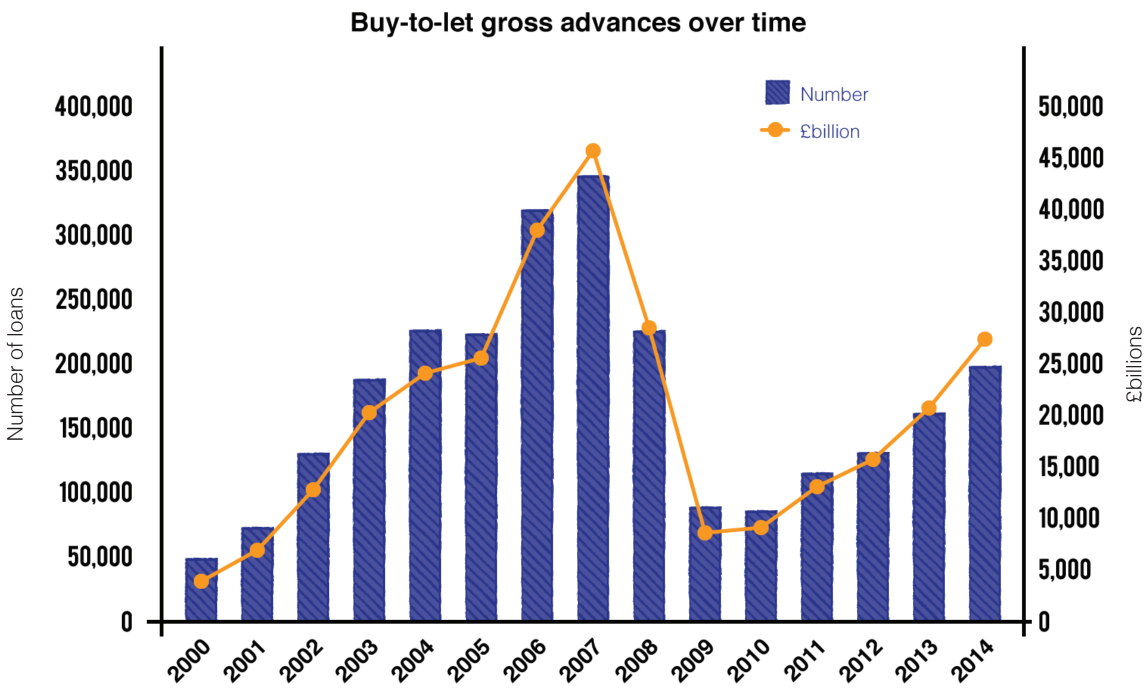
In 2007 figures from the Council of Mortgage Lenders (CML) show the total number of advances peaked at 346,000 with a value of £45.7 billion. Just two years later in 2010, volumes had dropped significantly to 85,200 (£9.1 billion) – the lowest level of lending activity in ten years.

By 2011 the market had started to recover as more lenders returned to the market, albeit with a cautious approach to new lending. At the end of 2011 the number of advances reached 114,900 and by 2012 this increased further to 130,300.

It was during 2013 the buy-to-let market started to gain more momentum; a step-up in recovery at the end of the year saw volumes increase to 160,900 and the value of lending reached £20.7 billion. In 2014 it was an even more positive story still with total lending at £27.4 billion.

Whilst we have seen strong growth in the market in the level of new lending, it is important to note that in absolute terms the market still remains smaller than it was ten years ago.

The market has made significant steps on the road to recovery and is performing well, however, we need to see further growth to enable landlords to further invest in quality PRS property to meet the increasing, and unwavering, demand from tenants.



Source: Council of Mortgage Lenders

AVAILABILITY OF BUY-TO-LET MORTGAGE FINANCE

The buy-to-let market has been gaining pace over the past 12 to 18 months with an increasing number of buy-to-let mortgage products coming to the market offering a greater variety of terms and Loan to Value (LTV) options.

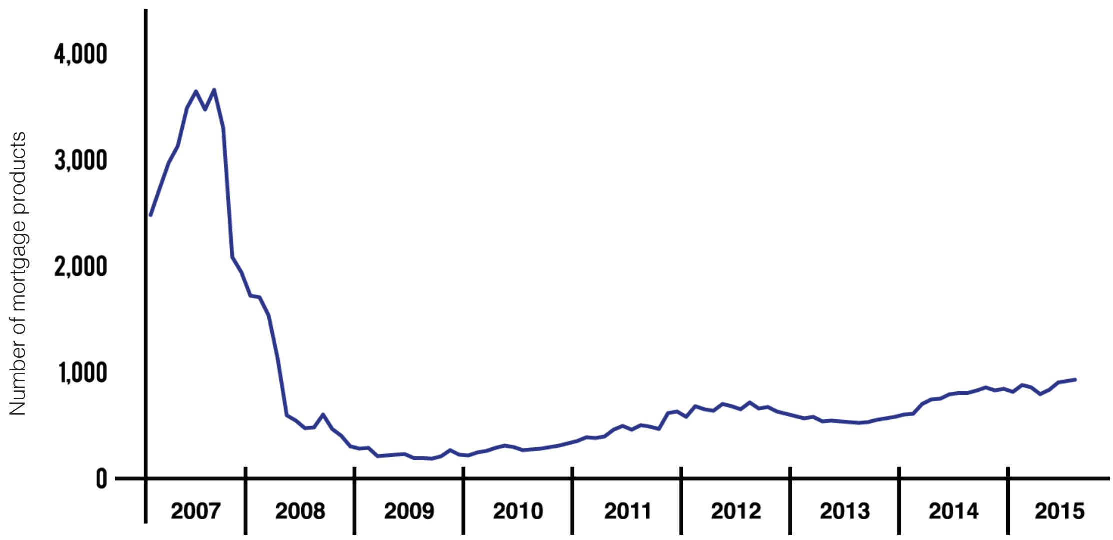
During its peak there were some 3,662 buy-to-let mortgage products available in the market. In July 2015 Moneyfacts' data showed there were 941 existing products.

As the figures show, the market is nowhere near pre-crisis levels of product availability, but in the last 12 months or so there has been a notable improvement. Progress has also been seen in the number of products available at a higher LTV, with 80 products with a maximum LTV of 80% (July 2015). There are still however, very few products at higher LTV bands, with just six products available at 85% LTV.

Landlord perception of the availability of buy-to-let finance has also improved. Paragon's PRS Trends survey, which tracks landlord views and confidence, shows that during 2011 landlords' perception of the availability of buy-to-let finance dropped to an all-time low. In the first quarter of 2011 just 17% of landlords thought buy-to-let finance was at least reasonably available, with 66% reporting it was either limited or very restricted.

Sentiment started to improve at the beginning of 2012 and throughout 2013 it climbed more positively every quarter, before levelling off in 2014 with an annual average of 42% of landlords viewing buy-to-let finance as at least reasonably available.

Number of available buy-to-let products



Source: Moneyfacts

STRONG CREDIT QUALITY

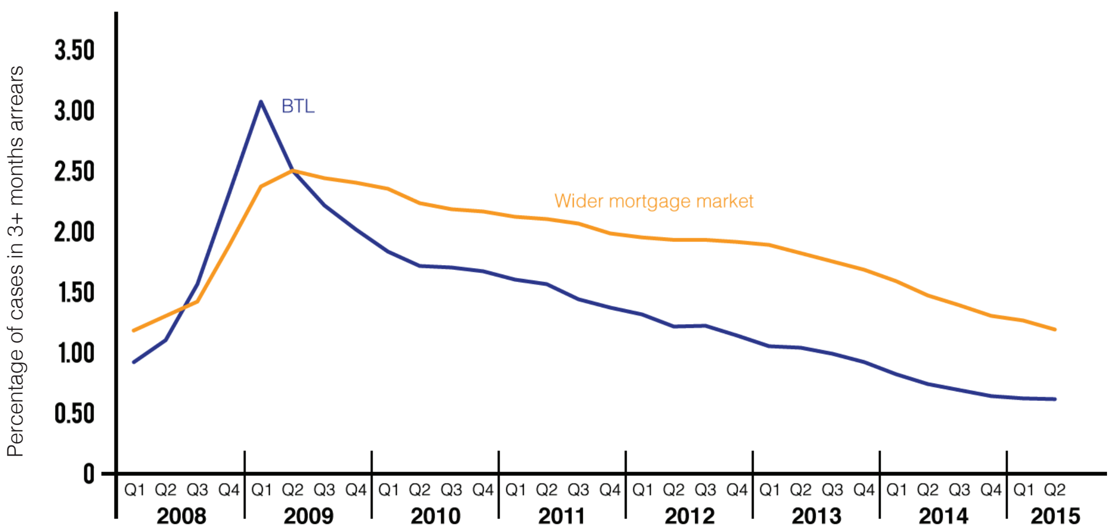
A common accusation levelled at the buy-to-let market before the financial crisis was that it was untested in recessionary conditions. After the worst economic environment for nearly 60 years, buy-to-let has been severely stress-tested and has proved it's resilience. Along with the rest of the mortgage market, arrears rose as the credit crunch hit, but from a very low base.

Buy-to-let arrears have been in decline since Q1 2009, after increasing in consecutive quarters during 2008, and once again sitting below arrears in the wider mortgage market. Arrears in the buy-to-let market have been below the wider mortgage market average since 2011.

In Q1 2015 the CML reported buy-to-let three month plus arrears of 0.70%, which is a decrease on the same time period last year (0.95%). In 2014 CML data showed an annual decrease from 2013, from 1.08% to 0.73%. Paragon's arrears have consistently out-performed both the buy-to-let market and the wider housing market, with 0.22% at the end of December 2014 and 0.20% in Q1 2015.

Inevitably, whilst the current interest rate will rise at some point, it is important to note here that landlords' rental investments are subject to stringent credit stress testing and lenders will ensure that a landlord can still meet their mortgage repayment terms should rates rise.

Arrears in buy-to-let market consistently lower than wider mortgage market



Source: Council of Mortgage Lenders

MORTGAGE FUNDING

The closure of the wholesale funding markets during the financial crisis severely impacted the wider mortgage market, preventing businesses from securing funding. This 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 de-regulation 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 £13 billion to £257 billion, growing from 2.5% of mortgage stock to 21.5% (CML data). However, the level of public RMBS issuance fell dramatically after Q2 2007.

This fall disproportionately affected the non-deposit taking lenders that 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 then Government's various lending stimulus schemes. Data from the CML shows gross new lending volumes by specialist lenders fell from 17.4% of total lending in 2007 to 3.7% in 2009, before recovering in 2010, reaching 5.5%. Since then there has been a more significant improvement and in 2014 the percentage of specialist lending totalled 9.0%.

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.

Returning securitisation to health has been a necessity for a well-functioning and vibrant mortgage market that supports a diverse customer base.

In November 2011, Paragon successfully launched its first securitisation transaction since the financial crisis. This was the first deal, market-wide, to consist solely of buy-to-let loans since 2007.

Since then Paragon has completed six further securitisation deals raising a total of £1.8 billion. Its most recent in July 2015, its sixty-first to date, clearly demonstrating the general appetite from investors for securities backed by high quality buy-to-let assets.

REGULATION AND BUY-TO-LET

It is vitally important that we foster a regulatory environment that encourages the continued participation of both residential property investors and lenders. The UK has chosen to recognise that purchasing and financing private rented property is a business activity.

A buy-to-let loan is essentially a business transaction. It is the borrower's intent to let property in which they are investing in order 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 personal guarantee is taken by the lender. In addition, there is minimal risk to the residents of the let property - ie the tenants - as they are protected by the terms of their tenancy.

It was therefore welcome news in early 2015 when HM Treasury took a pragmatic approach to the regulation of buy-to-let under the EU Mortgage Credit Directive (MCD), after finding no compelling case for wide-spread regulation of the market.

HM Treasury identified that only a small sub-section of the buy-to-let market who they named as "buy-to-let consumers" would be addressed under the MCD.

Below is an extract from HM Treasury's consultation, giving an example of what constitutes consumer buy-to-let, which would therefore fall subject to regulation.

> "There are some situations where borrowers do not seem to be acting in a business capacity. Examples of this may be where the property has been inherited or where a borrower has previously lived in a property, but is unable to sell it so resorts to a buy-to-let arrangement. In these cases, the borrower is a landlord as a result of circumstance rather than through their own active business decision. The government's view is that such borrowers are consumers and would need to be covered by an appropriate framework. We would expect such instances to represent a small proportion of total buy-to-let transactions, but would value views from respondents as to how many transactions may be subject to the appropriate framework."

More information can be found on the Government's website:
www.gov.uk/government/consultations/implementation-of-the-eu-mortgage-credit-directive/

Following the Treasury's announcement at the start of the year, in early June 2015 the Financial Conduct Authority (FCA) published its final response and policy statement in respect of the EU Mortgage Credit Directive and how they intend to approach the implementation of the regulation of 'consumer buy-to-let'.

The new framework by the FCA will come into effect by March 2016 for those in the mortgage industry lending or advising customers who fit the definition of 'consumer buy-to-let'. The FCA's approach is pragmatic and proportionate and the registration process is particularly straightforward for firms holding existing "part 4A" permissions.

However, the timetable for those affected by the changes remains tight given the scale of regulatory change elsewhere in the sector at present and some lenders may be forced to prioritise other developments ahead of 'consumer buy-to-let', thereby restricting access for consumers to these types of products in the early months following the March 2016 deadline.

REGULATION AND THE PRS

It is a common misunderstanding that the PRS is unregulated. The sector is, in fact, heavily regulated and landlords must comply with a wide range of rules governing the sector – over 50 Acts of Parliament and 70 sets of regulations according to the National Landlords Association (NLA).

Regulation already provides local authorities with the power to introduce local licensing schemes for the PRS, and places statutory obligations on landlords to check tenants' immigration status, follow appropriate electrical, gas and fire safety regulations, meet energy efficiency obligations and much more. There has been ongoing discussion about regulating the PRS further, whether that be by introducing licensing programmes in selected areas or the discussion around the need for long-term tenancies.

It is important that any new, or extensions of, existing measures are used with caution so that the sector can continue to grow in order to provide the level of housing demanded by tenants. Local Authorities already have extensive powers at their disposal, as do tenants and landlords. Education is the key here, making sure people know how to exercise the rights they already have. More unnecessary red tape will only hinder the PRS and the valuable role it plays in the UK housing market.

LONGER-TERM TENANCIES

There has been widespread, ongoing discussion and debate within the industry regarding the level of demand from private rented tenants for longer-term tenancies. Research commissioned by Paragon shows that despite the misconception, landlords are more than prepared to offer longer-term tenancies to those tenants who require added security.

In the second quarter of 2015 the average tenancy length was 2.6 years, this has been relatively consistent for the past two years. The length of tenancy can fluctuate between tenant types. In Q2, of those landlords renting to retired tenants the average length of tenancy was 3.1 years and for families three years. Students stayed, unsurprisingly, the shortest amount of time at 1.6 years.

At the end of 2014 landlords were asked the reason behind the end of tenancies across their portfolio, 71% said the tenancy ended at the tenant's request. What this research demonstrates is that tenancy length does vary on the type of tenant and their circumstances and in the majority of cases it is not the landlord who is actively ending the tenancy period.

Paragon are supporters of offering longer-term tenancies to those that require one, and were one of the first lenders to champion the Government's new model lease agreement of 36 month tenancies. However, one of the key motivators for those living in the PRS is the flexibility it provides, so going forward it is important the sector continues to offer flexibility to those that want it and security to those that need it.

Conclusion

It is easy to forget how far the Private Rented Sector (PRS) has come over the last 20 years. From a sector with falling household numbers, by 2015 it became the second largest housing tenure in England with a growing tenant base.

The sector has experienced considerable change, from improvements in quality, to the different types of people now calling the PRS home. Living in the sector is no longer seen as a last resort and is an active choice for many, for a huge variety of lifestyle reasons.

Whilst buy-to-let has been fundamental in enabling the PRS to grow, it has not been the reason for its growth. The sector has grown to accommodate more than four million households because of a sustained demand from tenants. The buy-to-let market will continue to develop finance to enable landlords to continue investing in the sector and provide homes for the millions of people that need them.

Just a few years ago, in the midst of one of the worst economic crises to hit the UK, the buy-to-let market was hit hard. In Paragon's 2013 edition of this whitepaper we focussed on a market on the long road to recovery. Today, we focus on a market continuing to recover but making great strides forward and we expect to see further growth in the coming years.

“TODAY WE FOCUS ON A BUY-TO-LET MARKET CONTINUING TO RECOVER BUT MAKING GREAT STRIDES FORWARD AND WE EXPECT TO SEE FURTHER GROWTH IN THE COMING YEARS.”

A note on sources

In this document we have referred to a number of sources and data by external bodies. All sources are clearly marked next to charts and graphs. A list of websites and various links are below, if you require additional information.

Council of Mortgage Lenders
www.cml.org.uk

Association of Residential Letting Agents
www.arla.co.uk

Department for Communities and Local Government
www.gov.uk/government/organisations/department-for-communities-and-local-government

The Migration Observatory – Oxford University
www.migrationobservatory.ox.ac.uk/

LSL Property Services Buy-to-let Index
www.lslps.co.uk

The Office for National Statistics
www.ons.gov.uk

The University of Cambridge 'The Private Rented Sector in the new century'
www.lse.co.uk/research

CBI – "Solid Foundations, attracting institutional investments to homes built for rent"
www.cbi.org.uk

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