

## **CEBS Consultation on guidelines to Article 122a of the Capital Requirements Directive (CP40)**

### **A response from the Paragon Group of Companies**

#### **Overview**

The Paragon Group of Companies welcomes the opportunity to respond to the Committee of European Banking Supervisors' consultation on guidelines to Article 122a of the Capital Requirements Directive (CRD).

Paragon is the United Kingdom's leading specialist provider of residential mortgages to professional and investor landlords. We launched our first specifically targeted private rented sector mortgages in 1995 and have specialised in this market over the last fifteen years. The company has been publicly listed for the last 25 years and is currently the UK's third largest lender of privately rented residential property finance. We have approximately 40,000 landlord customers and manage approximately £10 billion of loan assets.

We have extensive experience in the securitisation markets, having been the first UK company to securitise loan assets. All of our 53 securitisation transactions have been straightforward, transparent and low-risk and have performed well. Our use of securitisation has enabled us to completely match-fund our balance sheet, ensuring that finance is in place for the life of the underlying mortgages.

Pre-credit crunch, we financed one in ten of all residential investment property mortgages in the UK, helping to maintain a private rented sector that is playing an increasingly important role in the UK's housing market. Due to our conservative lending policies over many years, the performance of the mortgages we have originated is materially better than the industry average and as a result of this and our conservative funding methods we have remained profitable despite current market conditions.

#### **Paragon's involvement in the minimum retention debate**

Paragon's close interest in the debate on minimum retention in securitisation transactions is driven by our use as a non-deposit taking institution on wholesale funding in order to originate new loans. The proposed guidance on the application of Article 122a will significantly influence the securitisation market in which we operate and it is from this standpoint that we are responding to CEBS' consultation.

We recognise the importance from a public policy perspective of encouraging the return of a stable and sustainable securitisation market. While ensuring that securitisers maintain 'skin in the game', the new minimum retention regime must be implemented in a way that does not inadvertently prevent important sectors of the lending industry, such as non-deposit taking lenders, from making use of securitisation as a funding model.

We have a general concern that the new retention requirement contained in Article 122a could make securitisation deals less viable for non-deposit taking issuers and less attractive for investors, once implemented. There is a serious risk that this could hinder the re-emergence of the securitisation market at a time when this market will become increasingly important to sustaining the flow of mortgage lending. This is an outcome that the UK can ill afford given the fragility of the economy at the present time.

Paragon has been actively engaged in the debate on the new minimum retention regime over the last eighteen months, both at UK and EU level. In addition to direct representations

to and discussions with the European Commission and Members of the European Parliament, we have actively engaged with the UK Financial Services Authority on the issue. We remain seriously concerned that the detrimental impact Article 122a will have on non-deposit takers' business models is not being properly considered by policymakers. We have also been participating in the AFME CP40 working group, who as you are aware are providing a wider industry response.

### **Negative impact of Article 122a on non-deposit taking lenders**

Guidance on how national supervisors should implement the retention clause, and the new due diligence and risk management requirements for credit institutions investing in securitisation products, will have a significant impact on the revival of the securitisation market. It is vital that supervisors are given scope to exercise as much flexibility as possible in the way the new rules are implemented. If the guidance is too rigidly drawn, there is a real risk that securitisation models that have been used successfully and without any risk to financial stability in the past will be unnecessarily restricted.

Paragon's own interests are already aligned with those of our bond investors in the securitisations deals we have undertaken – the main objective of the minimum retention requirement in Article 122a – because of our practice of retaining all of the highest-risk 'first loss' tranche of bonds issued in our securitisations.

The minimum retention requirement will have a minimal impact on banks. In contrast, it will be highly damaging for non-deposit taking lenders. This is because the four alternative methods by which Article 122a permits originators to retain the 5 per cent interest in a securitisation do not accommodate non-deposit taking issuers' business models or approach to risk retention.

In particular, Article 122a ignores the risk of the underlying assets and therefore penalises prudent non-deposit taking lenders such as Paragon. Our arrears are low at 0.89 per cent, compared with a CML industry-wide average of 2.17 per cent and a CML buy-to-let average of 2.59 per cent. For low-risk mortgage transactions, we remain of the strong view that the 5 per cent retention requirement under the 'first loss piece' retention method should either be reduced or restructured, ideally on a risk-weighted basis.

The inflexibility of the retention requirement will make it very challenging for non-deposit takers to utilise securitisation on economic terms. As things stand, because as a non-bank we will have to fully fund the retention amounts with equity, we face a capital requirement that could be as much as 26 times higher than the capital requirements for banks taking a 5 per cent slice of a securitisation deal. It will be higher even than the capital requirement that banks would have to meet if they held unsecuritised assets on balance sheet.

The net effect of this is that non-deposit takers will be placed at a significant capital and cost disadvantage to banks. The retention requirement will, in its current form, create an unlevel playing field between banks and non-deposit takers and, as such, is anti-competitive. It will result in reduced competition in the UK mortgage market, significantly so in specialist sectors such as buy-to-let that is already suffering a serious lack of meaningful competition.

The consequences of this further decline in competition need to be set in a broader policy context. In the buy-to-let market in which Paragon operates, the existing shortage of mortgage finance for investment in the private rented sector will be exacerbated by the inability of non-deposit taking lenders to fully utilise securitisation because of the new restrictions imposed by Article 122a. As a direct consequence, supply of new privately

rented homes will become even more limited at a time when people are increasingly looking to the sector for to meet their housing needs.

It is vital, therefore, that the guidance produced by CEBS is sufficiently flexible for national supervisors to accommodate a range of business models, particularly those like Paragon's where there is no threat to financial stability and where the originator already clearly retains an exposure to the underlying assets that aligns their interests with those of investors.

### **Response to specific issues raised in CP40**

We have limited our submission to those aspects of the consultation paper that have the most direct impact on Paragon. Where our comments are not in response to a particular question, we have noted the specific sections or paragraphs of the consultation to which they relate.

#### ***Funding retained positions (Executive Summary, p.3)***

As noted above, the CRD is particularly onerous for non-deposit taking lenders who retain all of the equity in a deal through retention of the first loss tranche. This is because the CRD will now require this horizontal equity slice to represent a minimum 5 per cent interest in the securitisation. This compares to banks that can satisfy the CRD retention requirements in a more capital efficient manner through one of the other options available under Article 122a.

We welcome the request for views on the extent to which it would be possible for an originator, sponsor or original lender to use such retained funding positions for funding purposes. Raising funds on a secured, but full recourse basis, against some or all of the retained amounts held on balance sheet would not be incompatible with retaining the economic interest against such holdings, since there would be the same economic and accounting loss in the event that there was a failure to repay in respect of the retained interest.

Banks already have the ability to do this on an unsecured basis, by raising retail deposits to fund retained positions. Non-deposit taking institutions do not have the ability to raise retail deposits, and therefore funding for any additional retention amounts imposed by 122a would need to come either through equity, or by raising funds on a secured basis on the retained position. Funding through equity would be prohibitively expensive and having to do so would put non-deposit takers at a competitive disadvantage compared to banks.

Therefore, especially for non-deposit takers, it is particularly important that originators have the ability to raise funds on a secured basis against retained positions, and we would urge CEBS to make this clear in the guidance.

***Question 3. Do you agree with this differentiation in the role of a credit institution as hedge counterparty, and what issues might arise when credit institutions seek to determine whether their role as hedge counterparty results in the assumption of credit risk or not?***

Clearer guidance on swap transactions is needed, in particular FX swap transactions. Paragraph 8 on page 11 of the consultation puts the emphasis on whether or not there is exposure to principal losses. Whilst hedge counterparties do not have any direct exposure to principal losses, FX swap counterparties could suffer a loss on the MtM value to the swap if there were principal losses on the assets which resulted in shortfalls to the notes, and these bondholders received back less than the face value of the bonds. This would arise because the FX swap notional would effectively be reduced, and if the MtM to the

hedge counterparty was positive then the hedge counterparty would incur a loss on their hedge position on recognition of this reduction.

Therefore, categorising on the basis of whether or not risk is assumed arising from principal loss could result in incorrect misinterpretations. Ideally, the differentiation should be whether any hedge directly mitigates or reduces the exposure to the retention. Notwithstanding this, CEBS should, for the avoidance of doubt, confirm that all such FX swaps and similar interest rate hedges, hedging the interest and FX risk characteristics within the securitisation deal, should not be considered as assuming risk arising from principal losses, and therefore are allowable under the CRD.

### ***Consolidated Reporting (Paragraph 53)***

Whilst there is no explicit provision in Article 122a for non-deposit taking groups which report on a consolidated basis for accounting purposes to retain the 5% risk on a consolidated basis, we believe this must be implied and would welcome guidance allowing retention on this basis to satisfy the requirements. Whilst we understand that accounting treatment does not necessarily equate with capital treatment, as these entities are not subject to their own capital requirements they ought to be able to account for the retained exposure in the most tax/accounting efficient manner without the investor being penalised.

### ***Stress testing (Paragraph 69)***

Paragraph 4 requires stress testing to be carried out by credit institutions in a way that is appropriate to their securitisation position. The CEBS Guidelines on Stress Testing are principally focused on the firm-wide capital and liquidity of a credit institution, and not as investors in securitisations. Exposures vary significantly depending on the type and tranche invested in. It would be helpful and beneficial for investors if the guidance in this area incorporated a greater level of detail.

For example, for AAA investors, detailed cash flow analysis and modelling may not be appropriate in assessing the stressed position to the extent that this has already been carried out by the rating agencies based on more extreme stress assumptions than those the investor would anticipate or require in their analysis.

Often for investors in the more senior tranches, it would be more reasonable to expect that the analysis focuses more closely on other broader macro risks such as market, extension, margin and overall credit risk, rather than at the micro cash flow level which will focus on the final repayment rather than return risk. It would be helpful for the guidance to be more explicit in this respect.

### ***Questions 20 & 21 (Paragraphs 97-103) - Would disclosure templates that currently exist or are in the process of being prepared by trade associations, industry bodies, central banks, market participants or others fulfil these requirements on an adequate basis?***

Loan-by-loan templates are currently being prepared by AFME on behalf of the industry to comply with European Central Bank and the Bank of England requirements, and Paragon is participating with the various working groups on this. These will provide loan-by-loan data, which should facilitate cashflow analysis of the underlying exposures.

However these templates are not yet agreed and are not expected to be in place by the time the CRD comes into force in January 2011. When these standardised loan-by-loan templates do come into force they should provide adequate information for investors. We urge that a transitional period between the implementation of the CRD and the introduction

of the new templates should be recognised and permitted, and that securitisations should not be penalised where originators make loan-by-loan information available on an on-demand rather than published basis during that period.

There are other initiatives in progress, principally driven by the Bank of England related to the enhancements to their Discount Window Facility aimed at promoting the standardisation and provision of documentation, investor reporting and cashflow modelling. Like the new templates, these initiatives will be similarly helpful to investors when they are finalised and implemented.

However it should be noted that the information requirements of Paragraph 7 may still be satisfied on a bespoke basis on the transaction's own merits. Paragon already has extensive freely available investor reporting, and we have made available to investors loan-by-loan data. We are at the forefront of the industry in this regard. In relation to the new disclosure requirements, we therefore anticipate that we are already compliant with the requirements of Paragraph 7 relating to materially relevant information on the underlying exposures. It would be helpful if the guidance confirmed that bespoke reporting and data provision would also be capable of meeting the information requirements of Paragraph 7.