PARAGON BANK PLC

Response to the EBA's Consultation Paper EBA/CP/2015/03
Draft Guidelines on sound remuneration policies

paragon

Section 1: Introduction

1.1 Company overview

The Paragon Group of Companies PLC ('PGC') is the holding company at the top of a UK consolidated group (the 'Group') that has a number of wholly owned subsidiaries performing core functions. Founded in 1985, PGC is a FTSE 250 company listed on the London Stock Exchange and the UK's leading specialist buy-to-let mortgage lender. It is a specialist lender with 30 years' experience across a broad range of mortgage and consumer finance asset classes in:

- Loan origination
- Full in-house servicing
- Portfolio acquisitions

PGC is listed and a constituent of the FTSE 250 index, with a market capitalisation of circa £1.3 billion at 29 May 2015. The Group has £10.5 billion of loan assets under management. It has a prudent management philosophy and culture, demonstrating a conservative approach to business decision-making with price, rather than credit, being the key competitive driver for business volumes and balance sheet growth.

Since exiting the market place as an originator of consumer finance in 2008, the Group has been active in acquiring and servicing portfolios and has continued to monitor developments in relevant markets identifying a consolidation of market participants and an associated reduction in competition. Following a strategic review in 2013, the Group concluded that re-entry into household and small to medium enterprises ('SME') markets directly linked to its core competencies and experience would provide significant benefits for the Group, the markets, shareholders of PGC and the relevant customer base.

In order to re-enter these markets, the Group needed to secure a stable funding proposition. The funding model employed by the Group had relied on long-term, stable and conservative securitisation structures which were ideal for funding its mortgage originations. Such structures would not be readily available to support the consumer finance business. A number of funding options had been considered, for example bank loans, but the strategic review concluded that the most appropriate and sustainable long term option would be provided by a diversified funding structure with retail deposits at its heart.

Concluding the strategic review, the Group identified that the formation of a bank would be the most suitable vehicle to underpin a robust and sustainable business model for delivering consumer finance lending. The bank would sit alongside the other core entities within the Group, being fully capitalised by the Group holding company.

A vanilla savings offering was proposed in the initial launch, led by highly experienced personnel and managed on a platform run by the market-leading specialist in providing a scalable service for the industry. The development of the savings proposition provided further competition into the savings market and provided a secure home for savers. Paragon Bank PLC (the 'Bank') was launched in February 2014.

The Bank focuses on improving competition and choice for UK consumers and SMEs. It is based solely in the UK and offers straightforward, online savings products direct to consumers as well as loan products including car finance, buy-to-let and personal loans distributed via our trusted network of intermediaries. The retail deposits the Bank generates is only used to lend money to individuals who live in the UK, helping them and their communities to grow and prosper.

The Bank's strategy involves utilising the skills, infrastructure and capital of the Group in a manner that delivers prudent, profitable and sustainable growth in its chosen target markets.

The Bank believes it provides consumers with a competitive alternative to the large, established banks in the UK and the Group has been encouraged by the positive response from its customers and its shareholders to its strategic contribution within the "challenger bank" community.

As the banking subsidiary of the Group, the Bank is authorised by the Prudential Regulation Authority ('PRA') and regulated the Financial Conduct Authority ('FCA'). The Bank is also covered by the Financial Services Compensation Scheme. The Bank's corporate structure is an unusual one and does not easily align itself to the assumed structures set out within CRD IV, nor the EBA draft guidelines.

1.2 Key objectives for the Bank

The key objectives for the Bank complement the Group's objectives to grow shareholder returns in a stable and sustainable manner, maintaining responsible, open and honest dealing with its customers and creating stable employment and career opportunities for its staff. Operating in the UK consumer finance and SME markets, the strategy involves utilising the skills, infrastructure and capital of the Group in a manner that delivers prudent, profitable and sustainable growth in our chosen target markets.

Specifically, the key objectives are:

- Deliver a deposit-taking capability explicitly focussed on the excellent provision of essential banking services to households and SMEs
- Enhancement of the financial stability of the broader based lending business with diversification of funding providing a greater level of support to customers and delivering a reasonable return to shareholders
- Promotion of competition, innovation and liquidity in the relevant markets to give consumers more choice

1.3 Financial summary

PGC's half-yearly results were announced on 19 May 2015 and demonstrated strong profit growth; underlying profit increased by 10.4% to £63.9 million (2014 H1: £57.9 million) and the return on equity improved to 10.8% (2014 H1: 10.5%). The Bank origination flows continued to build across multiple products and deposit balances increased to £165.0 million.

The substantial increase in capacity and access to new and deeper funding markets, particularly through Paragon Bank has provided the platform to support further sustainable growth and diversification going forward. The Bank has made excellent progress since its launch and is on track to break even during the 2016 financial year.

1.4 The Bank's remuneration policy

The Bank's current remuneration policy applies to all individuals, whether permanent, temporary or fixed term, working within Paragon Bank and to those identified as an Approved Person for the Bank from the wider Group. It covers all remuneration that could have a bearing on effective risk management including salaries, bonuses, long-term incentive plans, options, hiring bonuses, severance packages and pension arrangements. It complies with the PRA's and the FCA's SYSC 19A: The Remuneration Code.

The policy provides the internal framework and remuneration structure to ensure the Bank establishes, implements and maintains effective remuneration for all individuals; to deliver a successful business on a sustainable basis, whilst promoting sound and effective risk management and to avoid exposing the Bank to excessive risks.

The Paragon Bank Board (the 'Board') owns the remuneration policy, which is managed under the Terms of Reference of the Bank's Remuneration Committee (the 'Committee'), as approved from time to time by the Board. The Committee undertakes to structure executive remuneration to take account of:

- The maintenance of a clear link between rewards and performance
- The objective of achieving an appropriate mix of fixed and variable pay
- The views of investors and shareholder bodies
- The UK Corporate Governance Code ('the Code')
- The need to encourage management to adopt a level of risk which is in line with the risk profile of the business as approved by the Bank Board
- Pay and benefit practice within the Group and within the sector
- Periodic peer group comparisons

The Bank's policy is to ensure that the executives are fairly rewarded for their individual performance, having regard to the importance of retention and motivation. The Committee determines the Bank's policy on executive remuneration and specific compensation packages for each of the Executive Directors. The fees for its Chairman and independent non-executive directors are agreed by the Board. The Committee also sets the remuneration of senior executives and for identified staff of the Bank.

The remuneration structure is based on performance against financial and risk measures and the Committee's assessment of the individual's personal contribution. The Bank's executives receive a combination of fixed and performance-related elements of remuneration. Fixed remuneration consists of base salary and benefits in kind contributions. Performance-related remuneration consists of participation in the annual bonus plan and the award of options under the Paragon Group Performance Share Plan ('LTIPs') from time to time.

Purpose and link to strategy	**Operation**	**Maximum opportunity**	**Performance conditions**
Base salary			
To provide a competitive, fixed cash component that reflects the scope of individual responsibilities and recognises sustained individual performance in the role	Remunerate fairly for individual performance, having regard to the importance of motivation Take into account remuneration levels in the Group as a whole, individual and business performance and objective research into comparable companies	Increases, if the Committee is satisfied with the individual's performance, will normally broadly follow those awarded for the rest of the Group Changes in the scope or responsibilities of a director's role may require an adjustment to salary above the normal level of increase	None

Benefits			
To provide market levels of benefits on a cost-effective basis	Private health cover for the executive and their family, life insurance cover of up to two times salary and company car or cash alternative, matching stakeholder pension contributions up to 6% Other benefits may be offered from time to time broadly in line with market practice	Private health care benefits are provided through third party providers and therefore the cost to the company and value to the executive may vary from year to year The maximum car allowance is £10,200 pa It is intended that the maximum value of benefits will be broadly in line with market practice	None

Annual bonus			
To incentivise executives to achieve specific, predetermined goals that drive delivery of the Bank's operational objectives over a one-year period To reward individual performance	Each executive's annual bonus is based on a challenging mix of financial, strategic and risk-related performance measures The annual bonus is non-pensionable	Maximum bonus potential is: a) Up to 100% of salary for the Managing Director b) Up to 50% of salary for the Finance Director c) Up to 30% of salary for the remainder of the Bank Executive For target performance a bonus of half of the maximum will be awarded, with additional amounts being awarded for exceptional performance For performance below threshold, no bonus is payable	The performance targets are set by the Committee at the start of the year with input, as appropriate, from the Bank Non-Executive Chairman and Non-Executive Directors The bonus is calculated by assessing performance against a range of personal and strategic objectives, relating to financial metrics, personal contribution and risk-related measures

LTIPs			
To incentivise executives to achieve enhanced returns for shareholders To encourage long-term retention of key executives To align the interests of executives and shareholders	An annual award of shares subject to continued service and performance conditions over a three year performance period The performance conditions used are reviewed on an annual basis to ensure they remain appropriate Awards are structured as nil cost options with a ten year life Executives are entitled to any dividends which accrue over the period on vested awards	Maximum award is 100% of salary in any year	Granted subject to passing a two tier test of challenging Group and Bank financial targets, tested over three years: a) Adjusted EPS and relative TSR targets for the Group b) A financial underpin applied by the Committee which will take into account the performance of the Bank over the period, including maintaining capital and liquidity at acceptable levels and an assessment of the risks incurred 25% of the awards will vest for threshold performance, with full vesting taking place for equalling or exceeding the maximum performance target

Sharesave share plan			
To provide all employees with the opportunity to become shareholders on similar terms	Periodic invitations are made to participate in the Group's Sharesave Plan A savings contract over three or five years with the funds used on maturity either to purchase shares by exercising options or returned to the participant The option is granted at a discount to the share price at the time of grant of up to 20% The Plan provides tax benefits in the UK subject to satisfying certain HMRC requirements and is operated on an 'all employees' basis	HMRC limits apply, with maximum allowable savings of £500 per month	None

Section 2: Response to the individual questions in the consultation

The Bank's response to specific questions has been provided via the EBA website link as requested. Where the Bank has not provided a response to a specific question, it believes the proposed guidelines are clear and has no comment to make.

Question 1: Are the definitions provided sufficiently clear; are additional definitions needed?

Definition "g." describes 'staff' as all employees of an institution and its subsidiaries, including subsidiaries not subject to the CRD, all members of the management bodies within that scope and any other person acting on behalf of the institution and its subsidiaries. This definition does not accord with the Bank's structural relationship to its parent company and the Bank suggests the definition is narrowed to employees of an entity. It would also be helpful to clarify this definition excludes third party contractors and those on secondment within the scope of CRD IV.

Definition "e." describes 'Long term incentive plans' as variable remuneration awarded at one point in time and under the same plan additional awards are made at future points in time subject to conditions, including e.g. the retention of staff within the institution. It would be useful to clarify whether this definition is also intended to cover deferred bonus plans, which are also awarded upfront and vest at a future point in time subject to continued employment and malus/clawback. It is understood, based on discussions at the public hearing on 8 May, that the above definition is not intended to cover deferred bonus plans.

Definition "l." states the award of variable remuneration means the granting of the amount of variable remuneration for a specific accrual period, independently of the actual point in time where the amount is paid. Definition "m." confirms an amount of remuneration 'vests' when the staff member becomes the legal owner of the remuneration awarded, independent of the instrument which is used for payment or if the payment is subject to additional retention periods or clawback arrangements.

The Bank notes section 120 refers to the calculation of the ratio between the variable and the fixed component of remuneration as being:

a. the parts of the long term incentive plans that are awarded at a later stage and are only awarded if the underlying conditions are met should be taken into account in the accrual period when the remuneration is awarded;
b. all upfront parts and parts to which no condition applies should be taken into account in the performance year where the long term incentive plan is awarded.

The Bank therefore seeks clarity on the EBA's meaning and use of the word 'award' in this context. Based on discussions at the public hearing on 8 May, it is understood that it is the intention of the EBA for firms to value LTIPs at the point of vesting. This is contrary to the approach taken by the vast majority of firms to date and could cause significant issues in the application of the bonus cap where LTIPs are operated.

The use of LTIPs is common practice within the UK financial services market and the wider UK corporate market. It is an instrument with which corporate shareholders are very familiar and comfortable. It is seen as an important retention tool for key executives within a company and focuses performance on the long term, rather than encouraging potentially increased and unnecessary risks for short term gain, at the expense of good customer outcomes. Therefore, LTIPs are seen to align executive and institutional shareholder goals.

The Bank recommends the calculation remains as now, i.e. as a percentage of basic salary for the purposes of monitoring variable pay awards granted in any given financial year. It is the Bank's belief this is a clear and transparent method to explain the variable remuneration award for any staff member to shareholders, with the relevant detailed justification.

To assist the Bank's recommendation and highlight the challenges of using the proposed approach within the consultation document, an explanation and worked hypothetical example is set out below:

- The Bank appoints its executive team and identifies its senior management structure
- Individual base salaries are recommended and approved in line with external benchmarking of job roles, to ensure the right individual is retained on a competitive salary

- Individual benefits packages are agreed which typically include company car/car allowance, private medical cover, defined contribution pension scheme, annual bonus based on performance and, in addition, currently the LTIP award
- The value of the bonus and LTIP is variable and will be dependent upon an assessment of the individual's contribution to the company and is set to provide recognition for what has been achieved to date compared to target (annual performance bonus) and an incentive to grow the business in the long term for the benefit of the customers, shareholders and employees (LTIP). Any variable pay award is in line with the Bank's remuneration policy
- An hypothetical example is described as follows:

	Current guidelines		Proposed guidelines	
Remuneration	Award	Value	Award	Value
Base salary	£100,000		£100,000	
Performance bonus	50% of base salary	£50,000	50% of base salary	£50,000
LTIP	100% of base salary at grant	£100,000	100% of base salary at grant 200% of base salary at vesting	£200,000 *assuming share price doubles during vesting period*
Fixed: variable total	1: 1.50		1: 2.50	

The current guidelines example demonstrates compliance with CRD IV (with shareholder approval for a ratio of 2: 1). By changing the guidelines to consider the LTIP value at vesting would mean this current structure is non-compliant and therefore to comply, the constituents of variable remuneration would need to be flexed annually to comply going forward.

In order to deliver the LTIP award in line with any existing contractual obligations, in this example, the company would be required to adjust the individual's annual bonus in respect of the year to zero. This may in itself present legal challenges and would be de-motivational to employees.

Definition "j." describes a 'bonus pool' as the maximum amount of variable remuneration which can be awarded in the award process. The Bank seeks clarification on whether the bonus pool includes any LTIP award, or just refers to the annual bonus award.

It is proposed that the guidelines will apply from 1 January 2016 onwards. It is therefore assumed that this will only apply for performance periods beginning on or after 1 January 2016. The Bank recommends that the EBA confirms this point in the final guidelines.

Question 3: Are the guidelines regarding the shareholders' involvement in setting higher ratios for variable remuneration sufficiently clear?

The Bank seeks clarification as to the frequency of shareholders' involvement in approving higher ratios for variable remuneration. Due to the cost and limited benefit of seeking annual approval, the Bank suggests that this would only need to be sought once, or if it needs to be periodically refreshed, approval should be sought every three to five years.

Question 4: Are the guidelines regarding remuneration policies and group context appropriate and sufficiently clear?

No. The guidelines propose to apply the specific requirements of CRD IV to the entire remuneration of Material Risk Takers ('MRTs'), even where part of the activities of these staff relates to non-CRD IV activities.

The Paragon Group of Companies PLC ('PGC') is the holding company at the top of a UK consolidated group (the 'Group') that has a number of wholly owned subsidiaries performing core functions. One of these subsidiaries is the Bank and it is only this subsidiary that is subject to CRD IV. As the banking subsidiary of the Group, the Bank is authorised by the Prudential Regulation Authority ('PRA') and regulated the Financial Conduct Authority ('FCA') and PRA. The Bank is also covered by the Financial Services Compensation Scheme. The Bank's corporate structure is an unusual one and does not easily align itself to the assumed structures set out within CRD IV, nor the EBA draft guidelines.

Since exiting the market place as an originator of consumer finance in 2008, the Group has been active in acquiring and servicing portfolios and has continued to monitor developments in relevant markets identifying a consolidation of market participants and an associated reduction in competition. Following a strategic review in 2013, the Group concluded that re-entry into household and small to medium enterprises ('SME') markets directly linked to its core competencies and experience would provide significant benefits for the Group, the markets, shareholders of PGC and the relevant customer base. In order to re-enter these markets, the Group needed to secure a stable funding proposition.

The strategic review concluded the most appropriate and sustainable long term option would be provided by a diversified funding structure with retail deposits at its heart and the Group identified that the formation of a bank would be the most suitable vehicle to underpin a robust and sustainable business model for delivering consumer finance lending. The bank would sit alongside the other core entities within the Group, being fully capitalised by the Group holding company. The Bank was launched in February 2014 and its strategy involves utilising the skills, infrastructure and capital of the Group in a manner that delivers prudent, profitable and sustainable growth in its chosen target markets. The Bank believes it provides consumers with a competitive alternative to the large, established banks in the UK and the Group has been encouraged by the positive response from its customers and its institutional shareholders to its strategic contribution within the "challenger bank" community.

In summary, the Bank is the authorised subsidiary of the Group, which is not itself subject to CRD IV remuneration requirements. The Bank seeks clarity on the wording within these proposed guidelines and refers to the public hearing on 8 May and specifically slide 7 from 11 regarding the application of

the remuneration requirements in a group context. This slide provides clarity for the Bank in relation to the legal structure of the parent company and the Bank suggests specific wording is included within section 7 of the proposed guidelines, to provide for the Bank's unique structure and relationship to its parent company.

Question 5: Comments on the chapter on proportionality

The Bank supports the proportionality principle and the objectives of the obligations, however, disagrees with the practicality of removing the 'neutralisations' applied under the previous guidelines. The size of the business means it is currently able to disapply the pay-out requirements as a tier 3 firm (the lowest proportionality tier in the UK). From launch in February 2014, the Bank has originated £85.6 million of loans and raised £165.0 million retail deposits. It employs 60 people and there is already PGC shareholder approval in place to apply the ratio between the variable components of remuneration and the fixed components to 200%. This is only applicable to one executive director role for the Bank, out of necessity, due to the remuneration structure of the package. Neutralisation means the Bank has the flexibility with remuneration structures to compete in the current market, to provide packages required to recruit and retain the best skills and experience to benefit its customers and employees, as well as the Group's shareholders.

In the event 'neutralisations' were removed; the additional hours and administrative cost for monitoring and governance requirements would be considerable in terms of amending policy documents, discussing and taking the minutes of governance committee meetings, auditing requirements, additional conversations with shareholders and additional dialogue in the annual report and accounts. Specific cost estimates for this approach are provided in more detail in response to question 22. In addition, the total remuneration for any of the executive directors, or any other staff members of the Bank, falls some way below levels that would classify individuals as high earners. There are 60 employees that would require monitoring and a review of the value of their total remuneration packages confirms none would be above the required reporting threshold.

The monitoring that would be required if neutralisations were removed would be extensive and disproportionate to the variable pay potential earnings. The removal of the minimum compensation rule would force a number of individuals with low variable remuneration to be caught within the scope of CRD IV pay-out process requirements, e.g. deferral. This may lead to the application of the rules on variable pay to very small bonuses, which would be impractical, make these roles less attractive and have a disproportionately high administration cost for reporting purposes. The Bank therefore strongly supports retaining the minimum compensation approach to the application of CRD.

The Bank urges the EBA to reconsider its proposed position on proportionality and recommends 'neutralisations' remain in place as long as the Group can demonstrate sound remuneration principles, complies with the required level of reporting and obtains shareholder approval for the Group's remuneration policy and application at regular intervals, i.e. every 3 years as currently carried out.

Question 16: Are the provisions on the award of variable remuneration in instruments appropriate and sufficiently clear?

The Group currently uses share based awards with dividend equivalents as a variable remuneration instrument for all eligible employees, including those employed by the Bank since its launch in 2014.

This is common practice in the UK for performance share plans as dividend equivalents are considered fair and reasonable to promote the long-term stability and performance of the company and have the support from the UK shareholder base, which like: the upfront knowledge of the measures being in place. Senior management are encouraged to align the business strategy to long-term growth and the Group and the Bank want to continue to use these variable remuneration instruments.

If the use of dividend equivalents is removed, it would prove challenging to manage those awards already "in flight" and so the Bank suggests this option is retained for both existing and future grants.

Question 22: Cost estimates that would be triggered for the implementation of these guidelines?

Cost estimates for implementing the guidelines as proposed are considerable, not only for one-off costs to review and restructure remuneration policies and practices, but also for ongoing monitoring costs. The estimated implementation costs equate to over £4,500 per Bank employee, with an ongoing cost of £1,500 per Bank employee, which highlights the additional burden the Bank will have to carry due to the proposed loss of proportionality.

Fixed costs will rise generally as the restrictions will reduce the size of variable compensation. This will impose a greater burden on the Bank and generally for the industry, especially start-up banks which will need to attract talent away from established organisations. The impact will be to the detriment of the competitive environment and ultimately customers.

The cost estimates and additional man hours required to process the changes on proportionality alone are as follows:

Task	Estimated internal man hours	Estimated internal cost	Estimated external advisor costs
Internal review and redrafting of current policy	40	£5,200	
External review of revised policy	15		£8,000
Remuneration Committee approval of revised policy	8	£10,000	

Task	Estimated internal man hours	Estimated internal cost	Estimated external advisor costs
Shareholder governance meetings to discuss proposed policy changes	100	£36,000	
AGM resolution draft and internal review to seek shareholder approval for revised policy	40	£38,500	£10,000
Identification of affected employees and a review of existing remuneration packages	40	£13,500	
Options for restructuring existing remuneration packages	20	£11,800	
Employment law advice on amendments to contract	15		£5,000
Remuneration advisor advice on options and next steps	15		£5,000
Consultation with affected employees	70	£18,000	

This equates to an estimated total of just over 360 internal man hours @ £133,000 and an external advisor cost of c. £28,000 to deal with the removal of neutralisations.

In addition, the estimated costs for implementing the other key changes around ongoing shareholder approval for the variable bonus cap, extending the deferral and retention periods, applying malus and clawback, identifying Material Risk Takers ('MRT') and managing the increased level of disclosure using the same approach as outlined above for the proportionality point has an estimated total of 300 internal man hours @ £85,000 and an external advisor cost of c. £40,000.

Ongoing costs around additional disclosure, governance of the MRT, and AGM preparations and approvals has an estimated total of 200 hours per annum @ £20,000.

Finally, it is highly likely additional specialist headcount will need to be recruited into the HR function namely someone with specialist compensation and benefits knowledge and experience of regulatory remuneration, to manage the ongoing requirements from these proposed guidelines, to ensure compliance and to ensure remuneration packages remain as competitive as possible for retention purposes. The Group operates with a low cost:income base of around 30% because of its organisational structure and it prides itself on managing its fixed costs efficiently to benefit its product pricing, customers and shareholders. The estimated cost for additional headcount is c. £65,000 pa with an initial recruitment cost of £15,000.

The Group and the Bank views all these costs as unnecessary and disproportionate considering the size of the organisation and the actual value of the individuals' remuneration packages.

Section 3: Conclusion

In summary, the Bank supports the principles of CRD IV and strives to uphold the highest standards with regard to MRT remuneration. It believes individuals should be appropriately awarded with a fair basic salary and then incentivised with the variable pay instruments currently available and familiar to the UK shareholder base. Strong company and individual performance should be appropriately awarded and individuals should be held accountable for their actions including the use of malus and clawback.

However, the Bank also believes that applying the EBA draft guidelines as proposed would have a negative impact for the business, its customers and its shareholders, particularly in terms of the neutralisations on proportionality. There is the risk of current remuneration packages being devalued as they would need to be restructured, with a likely rise in basic pay to compensate for the reduced potential variable element. The cost of implementation is considerable for the size of the Group and the total remuneration packages. The consequence is likely to be an increased risk of individuals not performing to the highest standard, as they would be less incentivised to deliver a performance that was to the benefit of all its stakeholders. It would also be more difficult to hold the individual to account in terms of receiving variable pay awards, as there would be less of the remuneration package available to apply the principles of malus and clawback.

The Bank therefore holds the firm view that the proportionality point should remain as currently applied within CRD IV and neutralisations should not be removed.