

**A response by The Paragon Group of Companies PLC (“Paragon”) to the Basel
Committee on Banking Supervision’s second consultative document on
“Revisions to the Standardised Approach for credit risk”**

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Introduction

Paragon is pleased to respond to the Basel Committee's second consultative document on Revisions to the Standardised Approach for credit risk.

It is our understanding that the content of the consultation is considered to be indicative, not a set of final standards, which have been published so that the Basel Committee can gather feedback from industry. Our submission is intended to be constructive, providing a compelling case for a reassessment of the proposed treatment of lending into the Private Rented Sector (PRS), including the buy-to-let (BTL) market.

Paragon is a listed UK-based lender with a 30 year track record. It is a constituent of the FTSE250 and has a market capitalisation of c £0.9billion.

Paragon was one of the first BTL lenders in the UK and remains an active participant today. Having operated in this market for 20 years the Group has originated £17billion of BTL loans during this period, incurring a realised loss rate of 0.47%.

Until February 2014, Paragon operated as a non-bank lender, financing its lending through the securitisation markets. In 2014, Paragon's banking subsidiary, Paragon Bank PLC, was authorised, from which point the Group was subject to consolidated supervision in addition to the direct supervision of Paragon Bank. The Group currently operates using the Standardised Approach (SA) but, given its extensive data set, robust underwriting and servicing procedures, we have indicated that we wish to move to an IRB basis in the future.

Our comments concentrate on the proposals as they relate to the residential real estate exposure class and support the presentation that was made to the task force at the outreach meeting in Basel on 17 February by the Group's Finance Director (Richard Woodman). Two specific areas are addressed:

1. PRS, including BTL, within income-producing residential real estate (IPRE) and the risk weightings being proposed
2. The basis for property valuations

Within the first section we will be demonstrating:

- the importance of the PRS market generally;
- the scale and maturity of the UK PRS Market, focussing on BTL; and
- the robust credit performance of BTL assets.

We trust that the assessment of capital that is required to support the PRS will be reviewed in the light of this feedback and that exposures will be treated in line with owner occupied residential real estate exposures. This outcome will be in line with an objective set out within the consultation - that the SA is appropriately calibrated to reflect, to a reasonable extent, the riskiness of exposures.

The second section addresses the valuation framework and concludes that the use of internal, professionally qualified, surveying teams should be considered positively. The current proposals suggest a presumption that internal valuation frameworks are inappropriate and open to management override.

Executive summary and key points

Lending against houses in the PRS, including the BTL market, should not be subject to penal capital treatment

The PRS is a critical element of the European and UK housing stock, performing a key role in housing provision and supporting the mobility of labour both within and between states. It should not be considered as ‘specialised lending’ (*Section 1.5 page 11 of consultation*).

The PRS in the UK has grown as a consequence of social, demographic and policy reasons, reflecting increasing demand from tenants for let property. Within the UK, the PRS is now the second largest form of housing tenure, supporting 5.2 million households, 30% of which is typically funded by BTL mortgages.

Lending specifically to finance private landlords was established in the UK in the mid-1990s under the BTL banner. As at 31 December 2015 the UK BTL market totals over £212 billion (per the UK’s Council of Mortgage Lenders “CML”).

BTL lenders in the UK tend to operate at low (sub-80%) loan to value ratios, have full recourse to their landlord customers and benefit from fast and efficient enforcement options (primarily around a receiver of rent process) which serve to minimise loss levels. Arrears levels as measured by the CML are typically lower for BTL than the broader residential, owner occupied, mortgage market.

The UK BTL market is dominated by banks operating on an IRB basis (approximately 70% of the market). The credit quality seen in these portfolios has been summarised by the PRA in its July 2015 publication, *Assessing Credit Risk under Pillar 2*, with the output suggesting an average risk weighting derived from these models of c12% compared to the 35% currently used under the standardised models.

Arrears data from the Building Societies Association and Paragon’s own arrears and loss data, evidences that this strong credit performance extends beyond the IRB banks to those operating under the SA.

A review of the credit performance of UK BTL collateral demonstrates that there is no basis for higher risk weights for BTL lending when compared to broader owner occupied residential lending and that the current risk weights under the SA represent an unjustified premium to the levels determined under the IRB basis. Paragon’s data and the data from the IRB banks does support a progressively higher risk weight being appropriate to lending at higher LTVs as recommended in the consultation paper, however, these should be calibrated in line with the risk weighting proposals being applied to owner occupied lending.

Finally, Paragon supports the case for a clear separation of the valuation process to underwriting processes, but that this should not prevent the use of in-house valuation teams comprising qualified surveyors who conduct valuation work in line with national professional standards.

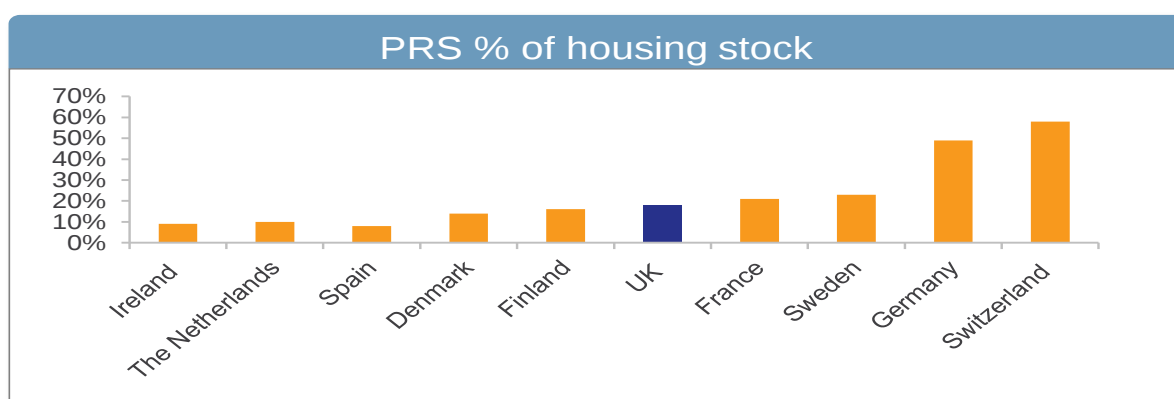
Private Rented Sector – a mainstream residential real estate segment

Within the consultation, the repayment of a loan that is materially dependent on the cash flows generated by the property is considered to be ‘the main characteristic used to define specialised lending.’ This specialised lending is then subject to capital requirements, for example, those laid out in paragraph 56, which introduces significantly higher risk weights (mapped against LTV) than for owner occupied residential real estate exposures.

We are concerned that the PRS, which is a significant segment of the residential real estate market, is captured within the definition of IPRE and is therefore being characterised as specialised lending. It follows that the consequence of these proposals is that this large segment of the market is subject to inappropriate capital requirements.

PRS - European overview

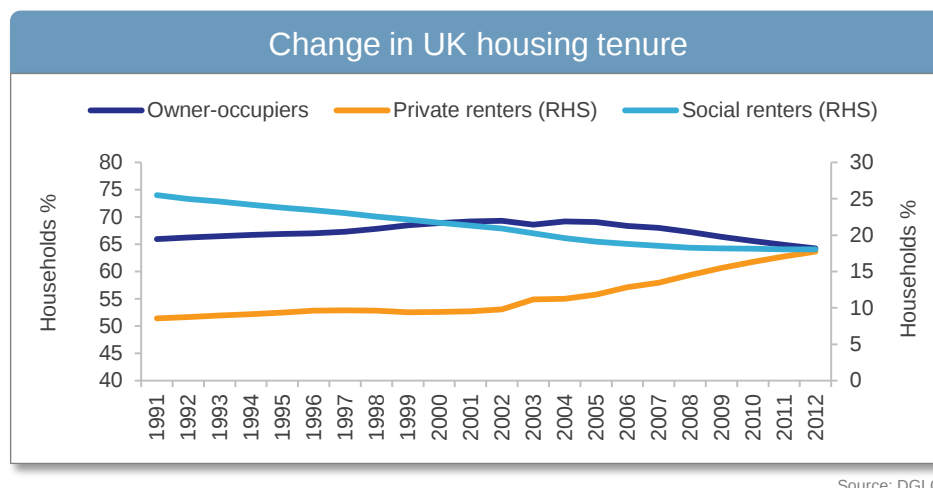
The PRS is a very large and important market across Europe, routinely representing around one quarter of the housing stock, with a far more substantial proportion in many countries.



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

Private renting forms an increasingly important role in the European economies, not least in facilitating the movement of people – few migrants enter a new market with the funds / credentials to buy their own home, indeed, surveys suggest that 5 years after having entered the UK, only 13% of migrants own their property.

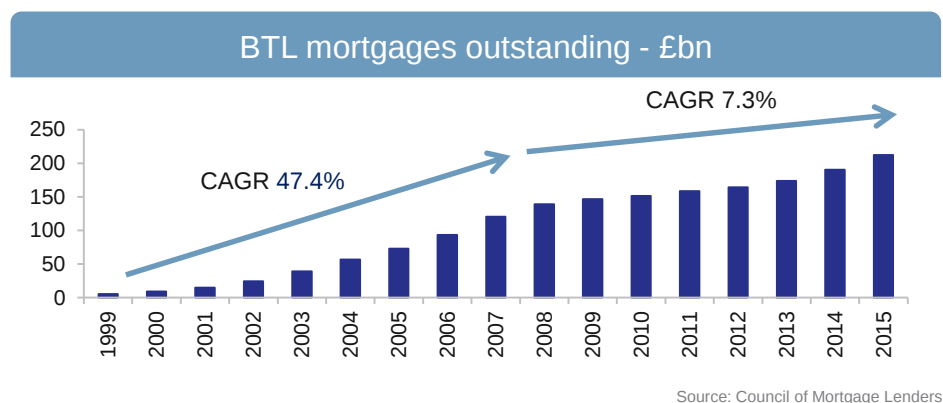
PRS - UK overview



The 1988 Housing Act formed the basis for the development of Private Renting in the UK, however, it wasn't until the mid-1990s that, in association with the Association of Residential Letting Agents, a small group of lenders (Paragon included) started to market a range of products specifically for private landlords – this is where the BTL term was created.

Growth, as measured by the statistics gathered by the CML, was rapid through the 2000's, in large part as a result of refinancing from the more traditional banking facilities used by landlords to finance their portfolios.

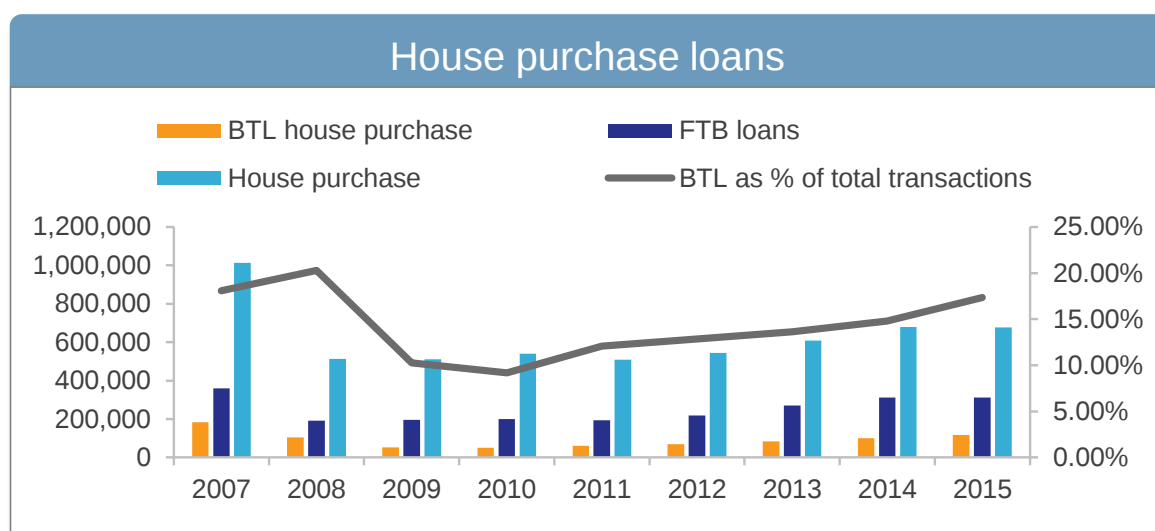
Since the global financial crisis, growth has been steadier, with a compound annual growth rate (CAGR) of just over 6%. Gross lending has, however, seen far higher levels, with almost 60% of lending being remortgage business.



Current market demand (UK)

Currently, demand for private rentals is very strong and today 5.2 million households rely on the PRS for housing provision. The sector has recently overtaken social housing as the second largest form of housing tenure in the UK.

The demand is driven by social and demographic factors (including population growth, net migration, student numbers, later household formation and the regulatory changes that have made obtaining an owner occupied mortgage increasingly difficult) whilst, at the same time, the UK has had a deliberate policy to reduce social housing provision.



Source: CML

According to the CML, there were £212 billion of BTL loans outstanding at the end of 2015. Putting this into a European context, the UK BTL market is similar in scale to the entire Belgian residential lending market and only the French, German, Swedish, Dutch Spanish and Danish mortgage markets are bigger.

BTL - asset performance

BTL loans generally display a lower level of arrears than the wider UK mortgage market. That lower level of arrears is driven by the fundamentals of the product, including the framework in which it is underwritten, how it is managed on an ongoing basis and the options that are open to a lender in an enforcement scenario.

The information in this section will provide the Committee with quantitative and qualitative analysis that demonstrates the strength of the BTL sector. Treating these assets outside of the wider portfolio of residential real estate exposures will be counter to the objectives set out for the SA review, primarily that the proposals:

'ensure the SA is appropriately calibrated to reflect to a reasonable extent the riskiness of exposures'

Building blocks for strong asset performance

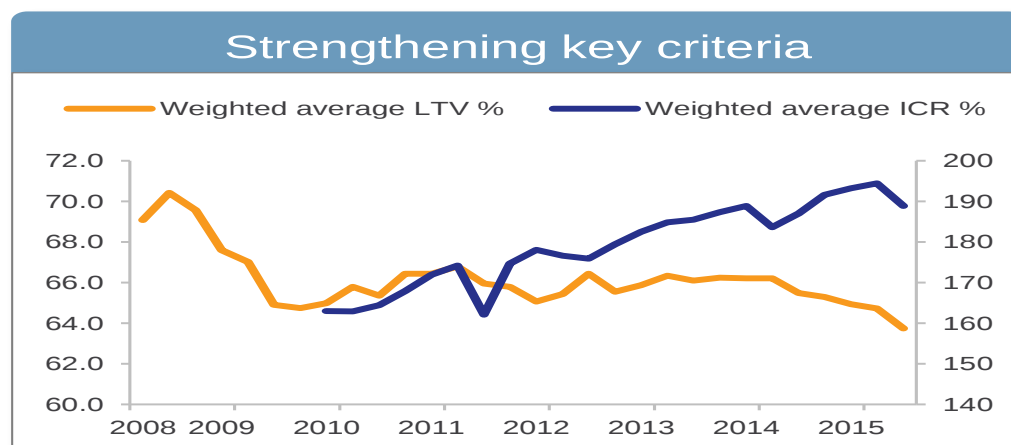
The strong performance of the BTL market within the UK is driven by the robust framework within which the assets are managed with specific options available to the lender that are not available on owner occupied residential lending. It is worth mentioning here that the legislative situation in the UK differs in part to that seen on mainland Europe, with stronger landlord rights in respect of rental levels and the powers to remove non-paying tenants in short order.

Underwriting

Underwriting analysis considers both the landlord borrower and the underlying property.

- For the landlord, credit history, non-property income, indebtedness, credit and insolvency scores are all used to assess suitability.
- For the property, its suitability to let and the sustainability of rental flows are critical elements of the lending decision, in addition to its basic valuation.

The CML's analysis of criteria (both LTV and affordability) suggests no weakening in the UK market and, indeed, at Paragon, between 2013 and 2015 our volumes rose fourfold and inception LTVs actually fell.



Source: CML

The level of deposit is a key driver in loss levels, as demonstrated by Paragon's portfolio loss experience, where total losses were:

- 11 basis points below 80% LTV;
- 65 basis points from 80 to 90% LTV; and
- 315 basis points above 90% LTV.

The relationship between LTV and lifetime loss levels at Paragon is shown in greater detail below:



Loan loss levels are at a de-minimis level below original LTV levels of 80%.

Landlord affordability is also a key ingredient in the lending decision. In addition to minimum income coverage ratios (at Paragon, this is 125% but averages nearer 162%), the landlords other income is assessed and affordability measured against the yield curve for the coming 5 year period. These other sources of income and wealth are important elements in the overall assessment of the customer.

Ongoing behaviour

Landlord behaviour can be evidenced by their investment decisions across the cycle. In the UK, the PRS continued to grow when house prices and economic growth fell, with investment levels being built around fundamental rental demand.

Enforcement

The lender has multiple options in the event of non-payment:

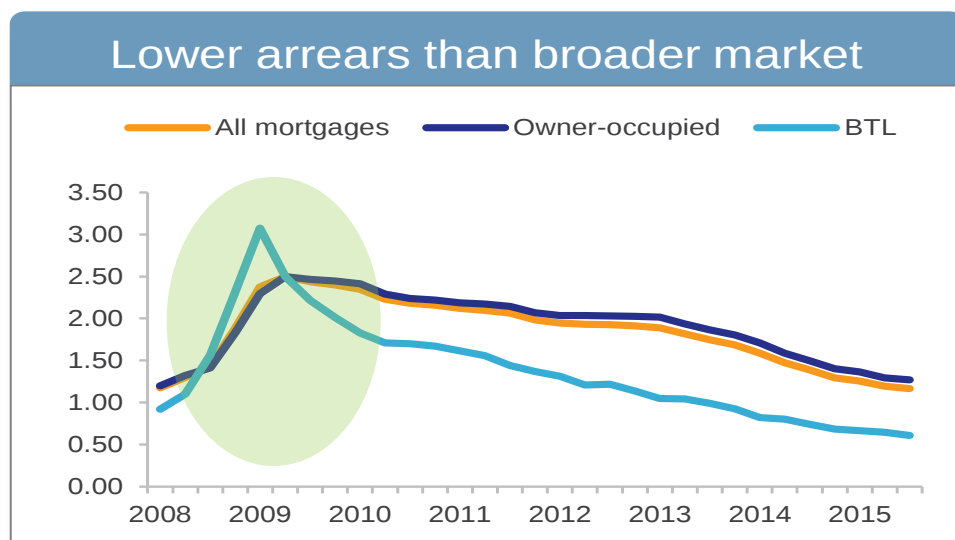
Lenders have rights to unopposed possession, rights of tenant eviction and the right to appoint a receiver of rent, which involves directing the tenant to pay the full rent to the lender rather than the landlord– to stand between the tenant and landlord. Having assessed the correct strategy for each account the lender can either sell the property with vacant possession or with a tenant in situ or if the landlord situation has improved then the rental stream can be paid thereafter to the landlord, assuming continued good performance.

The receiver can also hold and manage the property, with the intention to either sell at a later date or return to the landlord once the landlord's circumstances change.

By way of example: at Paragon we have taken just under 5,000 properties into receivership since we started lending in 1996:

- returning 32% to landlords;
- having 17% in stock; and
- having sold or in the process of being sold 51%.

The management of these cash flows effectively introduces a new set of credit risk mitigation techniques for the lender.



Source: CML

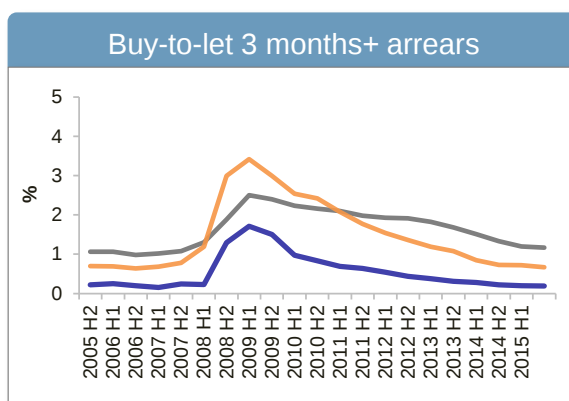
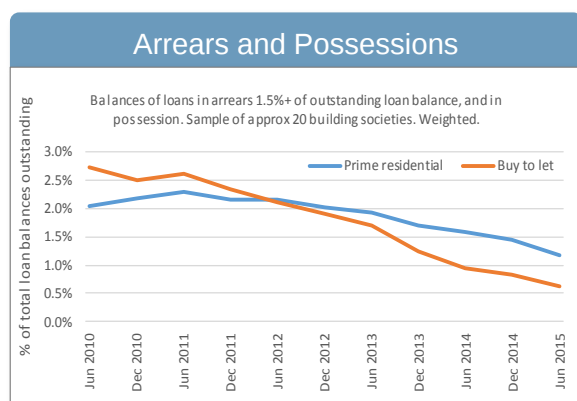
In H2 2009, the CML shows over 12,000 accounts in receivership, a level that dropped by 75% over the following three years as lenders managed their exposures downwards.

Impact of on arrears

It is important to understand that these arrears statistics are dominated by the performance of the IRB banks which comprise c70% of the market. Paragon's own history of arrears (operating on a standardised basis) and information received from the Building Societies Association both support this view of the market and are reproduced below.

UK Building Society data consistent with the broader CML statistics

As is Paragon's own data.....



Source: Council of Mortgage Lenders / Paragon

The table below provides a detailed analysis of the historical performance of the BTL lending by Paragon. The output is quite clear – that the performance of the assets is exceptionally strong.

Original LTV Band	Number of loans	Original advance	Realised losses	Realised losses
	#	£m	£m	%
<=50%	3,453	£398.2	£0.1	0.03%
>50% <=60%	4,244	£599.2	£0.2	0.04%
>60% <=70%	10,679	£1,586.5	£1.4	0.09%
>70% <=80%	35,740	£5,001.1	£6.8	0.14%
>80% <=90%	72,213	£8,910.6	£58.4	0.65%
>90%	2,629	£414.7	£13.1	3.15%
	128,958	£16,910.3	£79.9	0.47%

Source: Paragon 31-Dec-15

BTL - Participation of IRB banks in the sector

Despite often being characterised as a small, specialised lending sector, latest statistics (December 2015) show over £212 billion of BTL receivables in the UK. Looking at the £190 billion (per the CML) at December 2014, over 68% was held by banks utilising an IRB approach, with over £110 billion held by the top five banks.

Extensive modelling and stress-testing by those IRB banks generates an average risk-weight in the low teens.

Credit risk IRB benchmark				
	Standardised	Exposure weighted		
		Average	Low	High
<50%	35.0%	4.1%	3.5%	4.7%
50% to <60%	35.0%	9.7%	8.2%	11.1%
60% to <70%	35.0%	12.5%	10.6%	14.4%
70% to <80%	35.0%	17.5%	14.9%	20.2%
80% to <90%	36.0%	32.0%	27.2%	36.8%
90% to <100%	43.0%	43.1%	36.7%	49.6%

Source: Assessing Capital Adequacy under Pillar II, PRA, January 2015

Paragon, as the largest SA organisation in the UK, has equally impressive credit metrics (as detailed above) but is required to hold at least 191% more capital than its competitor IRB group. As a consequence, the SA banks are forced to focus their activities at higher LTV

lending – a review of the top lenders at 60% and 65% LTV show the IRB banks dominating the market, entirely as a result of their preferred capital ratios.

Further dislocation resulting from the even higher risk weights proposed under the SA potentially price SA banks out of the market, impacting the supply of credit for this material and high-performing segment of the housing market.

PRS and BTL - conclusion

Through the analysis set out above there are three clear conclusions:

1. That lending against houses in the PRS should not be categorised as ‘specialised lending’. The sector is significant and provides a dynamic within the mortgage market that supports free movement, flexibility and choice not just in the UK but across Europe.

Its role is comparable to that of social housing where repayment also depends on the cash performance on the properties financed. This niche segment, per the consultation will be treated in line with owner occupied residential lending.

2. Paragon’s data and the data from the IRB banks does support a progressively higher risk weight being appropriate to lending at higher LTVs as recommended in the consultation paper, however, these should be calibrated in line with the risk weighting proposals being applied to owner occupied lending (Paragraph 54 of the proposals).
3. That the credit and ‘riskiness’ fundamentals are robust and to suggest that the BTL lending ought to attract a significant capital requirement that is out of line with owner occupied residential real estate exposures is inappropriate; a contradiction to the objectives of the SA review.

The Committee could consider the appropriateness of the UK BTL market as one where a minimum global standard to be applied to the asset class could be calibrated. We would expect supervisors in less developed markets to consider a requirement for higher levels of capital that reflect local concentrations, legal structures and evidenced performance levels.

Approach to property valuation

The consultation paper currently states (on Annex 1, paragraph 52 note 46) that valuations must be carried out independently from the banks' mortgage application processing and loan underwriting process. Paragon fully endorses this view but is keen to establish that in-house surveys, suitably separated from the underwriting process and performed by RICS-qualified surveyors employed by the Group will meet this criteria. The use of the in-house expertise is an important credit differentiator for Paragon and we would be keen to maintain this operating structure.

At Paragon, in-house surveyors carry out the surveys on approximately 50% of new business flows and perform an audit role as the other 50% surveys which are undertaken by an approved panel of external surveyors. We detail above the strong credit profile demonstrated by Paragon's BTL portfolio and, in turn, the appropriateness and value credited by this surveying approach.

Responsibility for the surveying operation rests with the Group's Chief Operating Officer, rather than that of the Director of Mortgage lending and the Group's property risk function (providing second line support) reports to the Group's Chief Risk Officer, ensuring a proper segregation for the function.