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HQLA eligibility and BTL mortgages

Addressing the incongruity between covered bonds and RMBS

International Securitisation Research

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- Long a stalwart issuer of BTL RMBS, Paragon Bank (**PAGLN**) sold its inaugural, UK benchmark covered bond this week at **SONIA+60**. The bond represents a first in the public UK covered bond market, as **PAGLN**'s £966mm cover pool is comprised entirely of buy-to-let (BTL) mortgages.
- Paragon Bank's decision to issue covered bonds represents a notable shift in its secured funding strategy, as it has become much less reliant on BTL RMBS issuance in recent years amidst a sharp increase in retail deposits, last marketing **PARGN 26** in mid-2019. The shift to covered bonds better optimises funding cost relative to BTL RMBS, as the likely 10bp+ differential between **PAGLN**'s pricing level and the clearing level for a new BTL RMBS senior (~**SONIA+70/L70s**, in our view) is more meaningful than the slim (or even inverted) differential between UK covereds and Prime RMBS.
- What stands out to us is that, for UK investors, the new covered bond is intended to be treated as HQLA Level 1 under the Liquidity Coverage Ratio. This stands in stark contrast to the treatment of senior BTL RMBS, which are ineligible to be HQLA assets at all, even if *STS*-compliant, given the requirement that residential loans collateralising Level 2b securitisations be "*granted to individuals for the acquisition of their main residence.*"
- While we of course note the benefit of the dual-recourse nature of covered bonds, we think that the blanket exclusion of senior BTL RMBS from being HQLA Level 2b is incongruous to the most favourable treatment of UK covereds with BTL mortgage exposure. We don't argue against the validity of the Level 1 treatment of such covered bonds, but rather want to advocate for the *possibility* of BTL RMBS being Level 2b by addressing the inherent discrepancy in the eligibility of BTL mortgage collateral.
- While there are several UK BTL RMBS shelves that securitise 100% prime BTL mortgages, only Shawbrook Bank has opted to obtain the *STS* label for their deals, as the current lack of HQLA eligibility mitigates some of the label's benefit. We think that the rigorous and numerous eligibility criteria to receive the *STS* label, as well as ongoing transparency requirements, provide a strong quality check for securitisation. Thus, the *STS* prerequisite for HQLA Level 2b securitisations, and the fact that BTL RMBS deals are *STS* eligible, suggests that the ineligibility of BTL mortgages under LCR could be outdated.
- Though there are other hurdles to address, expanding the eligibility for HQLA Level 2b securitisations to include BTL RMBS could encourage more BTL issuers to seek the STS label, and broaden participation in BTL RMBS deals. As STS-compliant UK BTL RMBS seniors already achieve the same 10% risk weight as UK covered bonds for UK bank treasury investors under the ERBA, we think that opening up BTL RMBS to be HQLA Level 2b would be a step forward for the securitisation market in a manner that doesn't jeopardise the intent of the regulation.

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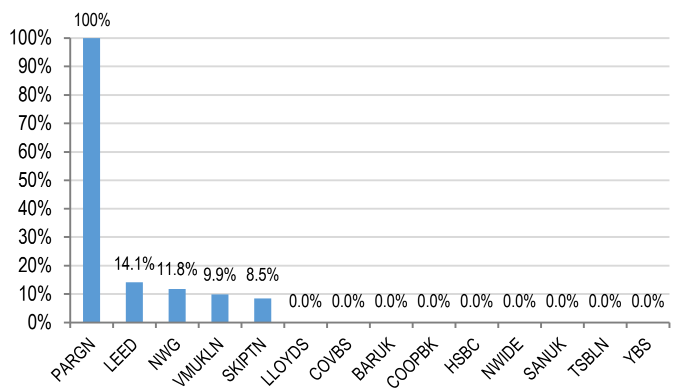
LCR and HQLA Level 2b: Is it time to rethink BTL mortgages?

This week, Paragon Bank (**PAGLN**) sold its inaugural, UK benchmark covered bond (**PAGLN 0% 03/20/2028**), a £500mm, 3Y SONIA-linked FRN (with expected rating of Aaa/AAA by Moody's/Fitch), at **SONIA+60**. **The bond represents a first in the publicly distributed UK covered bond market, as PAGLN's £966mm cover pool is comprised entirely of buy-to-let (BTL) mortgages**. As our colleagues in Covered Bond Strategy recently discussed, most of the public covered bond programmes from UK banks and building societies feature exclusively owner-occupied mortgages in their cover pools. As **Figure 1** shows, only Leeds Building Society, NatWest, Virgin Money, and Skipton Building Society include a minority share of BTL mortgages in their programmes. While we note that the cover pool for Coventry Building Society's Godiva covered bond programme is also comprised 100% of BTL mortgages, those bonds have not been publicly placed with investors, but primarily retained by Coventry for use in central bank repo operations; instead, the cover pool for Coventry's distributed covered bond programme contains only owner-occupied mortgages.

Figure 1: Concentration of BTL mortgage loans in the distributed covered bond programmes of various UK banks and building societies

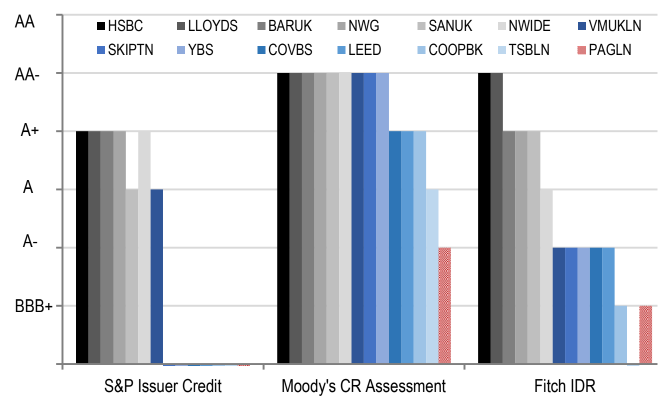
%



Source: J.P. Morgan, Dealogic, Bloomberg Finance L.P.

Figure 2: Comparing issuer ratings across S&P, Moody's, and Fitch for UK covered bond issuers

Current rating



Source: J.P. Morgan, Bloomberg Finance L.P., Rating agencies

The inaugural **PAGLN** covered bond attracted strong demand, with a final order book size in excess of £1.4bn, or an equivalent final coverage ratio of 2.8x. Accordingly, the bond was able to tighten 5bp from guidance of **SONIA+65a**. As anticipated by our covered bond strategists (who expected the bond could price in the range of SONIA +H50s/L60s), **PAGLN**'s pricing level represented a modest pickup relative to recent benchmark UK covered bonds, with Virgin Money/Clydesdale Bank selling a 3Y covered FRN (**VMUKLN 0% 01/22/2028**) at **SONIA+53** in late January. **While this pickup should partially reflect the 100% BTL composition of the cover pool, it also likely reflects PAGLN's modestly weaker issuer profile**, as Paragon Bank has a Counterparty Risk assessment of A3 from Moody's (Issuer Rating of Baa2), and an Issuer Default Rating of 'BBB+' from Fitch. **Figure 2** shows that these ratings are lower than those typically seen across most other covered bond issuers, with the partial exception of **COOPBK**, which also has an IDR of 'BBB+' from Fitch.

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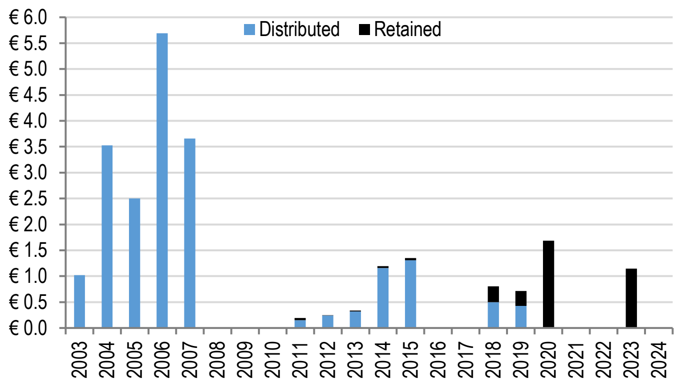
Paragon Bank's decision to issue covered bonds represents a notable shift in its secured funding strategy, as it has become much less reliant on RMBS issuance over the past several years. Originally established in 1985 as a specialist lender, Paragon was long a stalwart issuer of BTL RMBS, launching its first securitisation transaction back in 1987. In the pre-GFC era, Paragon was one of the most visible issuers of BTL RMBS via its **Paragon Mortgages** platform (**PARGN**), placing between €2.5bn to €5.7bn of supply *per year* from 2004-2007 (**Figure 3**), representing 36% of total BTL RMBS sold over this 4-year period. After a multi-year hiatus in the immediate wake of the GFC, Paragon resumed BTL RMBS issuance in 2011, and sold just over €3bn of bonds from 2011-2015, or nearly 70% of total BTL RMBS issuance over this period.

Figure 3: Annual distributed and retained UK BTL RMBS issuance from the PARGN programme

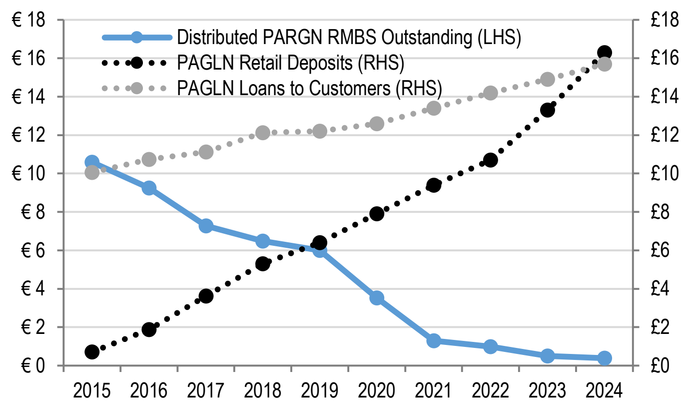
€bn



Source: J.P. Morgan, Concept ABS

Figure 4: Outstanding, distributed PARGN UK BTL RMBS issuance

€bn (LHS) and £bn (RHS)



Source: J.P. Morgan, Concept ABS, Bloomberg Finance L.P., Paragon Bank Annual Reports

However, after obtaining its banking license in 2014, **Paragon has gradually disappeared from the distributed RMBS market over past 10 years as it has shifted increasingly towards deposit funding**; the bank's retail deposits have risen substantially, from £0.7bn in FY 2015 to £16.3bn in FY 2024, while loans to customers have increased from £10.1bn to £15.7bn over the same period (**Figure 4**). Paragon last publicly marketed a BTL RMBS, **PARGN 26**, in mid-2019, from which the 3.0Y Class A1 notes (with 13.5% initial credit enhancement) priced at **SONIA+105**. Following the redemption of that transaction at its Optional Redemption Date in Aug-24, **there are now no publicly marketed, post-crisis PARGN bonds outstanding**. Only €365mm of **PARGN 12**, issued in July 2006, remains outstanding, as do 3 fully retained transactions totalling €2.5bn (**PARGN 27**, **28**, and **29**, issued in Apr-20, Nov-20, and Nov-23, respectively, and with corresponding Optional Redemption Dates in Oct-25, Dec-25, and Dec-28).

Noting both the £5bn capacity of **PAGLN**'s new covered bond programme and the absence of publicly marketed BTL RMBS in the post-COVID period, the shift to covered bonds does seem to better optimise Paragon's funding cost. When compared to UK BTL RMBS, **PAGLN**'s pricing level of **SONIA+60** is 5bp tighter than the post-GFC tights achieved by a publicly marketed, UK BTL RMBS senior, of **SONIA+65** in Sep-21 on Shawbrook Bank/TML's **LNBRK 2021-1**. Furthermore, the last publicly marketed UK BTL RMBS senior priced at **SONIA+83** in late Oct-24 (LendInvest's **MORTI 2024-MIX**), while the Class A notes from West One's **ELSTR 251-1ST** UK

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NCF RMBS (with a ~66% BTL concentration) more recently priced at **SONIA+72** in February. **Thus, the likely ~10bp+ differential between the realised pricing level for PAGLN's inaugural covered bond and the likely clearing level for a new BTL RMBS senior (~SONIA+70/L70s) is much wider than the slim (or even inverted) differential between UK covered bonds and Prime RMBS**. To highlight, this week Virgin Money/Clydesdale Bank sold a 3Y UK Prime RMBS senior from its **Lanark** master trust, **LAN 2025-1 1A**, at **SONIA+47**, which is 6bp tighter than where the issuer sold its 3Y covered FRN at the end of January.

What stands out to us is that, for UK investors, the new covered bond is intended to be treated as HQLA Level 1 under the Liquidity Coverage Ratio, and HQLA Level 2a for EU investors. **This stands in rather stark contrast to the treatment of senior BTL RMBS bonds, which are categorically ineligible to be HQLA assets at all**, even if *STS*-compliant, given the regulation's requirement under Article 13, paragraph 2(g)(i) that residential loans collateralising Level 2b securitisation positions must be "*granted to individuals for the acquisition of their main residence*."

This blanket exclusion of AAA-rated, BTL RMBS from being HQLA Level 2b given the restriction of eligible residential mortgage collateral to only owner-occupied loans is, in our view, incongruous to the most favourable, HQLA Level 1 treatment (for UK investors) of the PAGLN covered bond, which has recourse to a pool of 100% BTL mortgages– or any other covered bond with a share of BTL mortgages in the cover pool. Collateral eligibility for Level 1 covered bonds (i.e. 'extremely high quality covered bonds') calls upon Article 129 of the CRR, which sets out eligible residential mortgage collateral quite simply as "*loans secured by residential property up to the lesser of the principal amount of the liens that are combined with any prior liens and 80% of the value of the pledged properties.*"

We of course note the benefit of the dual-recourse nature of covered bonds, with full recourse to both Paragon Bank (with a shortfall claim on its estate in an insolvency scenario) and the cover pool; interest and principal payments on the bond are an obligation first of Paragon Bank itself (and not the cover pool), until an issuer event of default. UK covered bond legislation utilises the Structured/Guarantor model, where covered bonds are *unsecured* obligations of the issuer, with proceeds from the covered bond sale on-lent to a guarantor (usually an SPV, in this case Paragon Covered Bonds LLP) and used to purchase the collateral from the issuer; the SPV provides a guarantee to covered bondholders as to payment in the event of issuer default. With this in mind, **we don't argue against the validity of the Level 1 treatment of the covered bond, but rather want to advocate for the *possibility* of BTL RMBS being Level 2b by addressing the inherent discrepancy in the eligibility of BTL mortgage collateral**.

We also recognise that many BTL RMBS deals, as currently structured, still wouldn't be HQLA Level 2b eligible given the inclusion of second-lien mortgages or non-conforming exposures to credit impaired borrowers (the latter of which would also preclude *STS* eligibility). However, there are still several BTL RMBS shelves that securitise 100% prime BTL mortgages, including Shawbrook Bank's **Lanebrook** platform (**LNBRK**), OneSavings Bank's **PMF** shelf, and Hampshire Trust Bank's **Winchester** programme (**WNCHR**), among others, while other issuers could also likely structure transactions in a similar manner. **At present,only Shawbrook Bank has opted to obtain the *STS* label for their LNBRK deals,** as the current lack of HQLA Level 2b eligibility for BTL RMBS seniors mitigates some of the benefit of the *STS* label, particularly given the substantial amount of work that's required to do so.

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On this point, **we think that the rigorous and numerous eligibility criteria to receive the *STS* label, and the ongoing transparency requirements under the Securitisation Regulation, are inherently a quality check for securitisation transactions**; after all, the *STS* label was established to distinguish 'high quality' securitisations, and facilitates preferential capital treatment for bank treasury investors relative to non-*STS* exposures. Thus, the *STS* prerequisite for HQLA Level 2b securitisations, and the fact that BTL RMBS deals are eligible to be *STS*, **suggests that the specific ineligibility of BTL mortgages under LCR could be outdated in the post-Securitisation Regulation era**.

Moreover, **the BTL RMBS sector has a track record of strong performance**, particularly those securitisations that are backed by new BTL originations vs. pre-crisis mortgages. We highlight that Paragon's last publicly marketed UK BTL RMBS, **PARGN 26**, had a peak 90D+ delinquency rate of 0.85% and a cumulative loss rate of 0.006% prior to redemption. Meanwhile, 90D+ delinquency rates on the *STS*-compliant **LNBRK 2021-1**, **2022-1**, and **2023-1** transactions total 0.85%, 0.06%, and 0.16%, and all have zero cumulative losses. Looking more broadly, Moody's UK BTL RMBS performance index shows a peak cumulative loss rate for the sector of 0.89%. With initial credit enhancement on recently issued Class A notes averaging almost 12.5% (with a range of 10-14%), **BTL RMBS senior bonds offer ample protection from performance deterioration**. Though the first layer of recourse for a covered bond is not to the cover pool, we nevertheless mention that almost one-third of the BTL mortgages in **PAGLN**'s cover pool were originated pre-GFC.

Apart from the condition that eligible residential mortgage collateral for Level 2b securitisations must be owner-occupied loans, **there is an additional obstacle in Article 13 of the LCR regulation that would still need to be addressed to allow for BTL RMBS to be HQLA Level 2b eligible**. Article 13, paragraph 3 states that "*The repayment of the securitisation positions shall not have been structured to depend, predominantly, on the sale of the assets securing the underlying exposures. However, this provision shall not prevent such exposures from being subsequently rolled-over or refinanced*." **Given BTL mortgages are predominantly interest only loans, it can be interpreted that BTL RMBS bond repayment is dependent on the sale of the underlying properties**, if there is no benefit ascribed to the First Optional Redemption Date in the structure (and the incentive for the issuer to call via step-up margins) or to reasonable prepayment assumptions. However, in our view, this is yet another inconsistency in the collateral eligibility criteria of securitisations versus covered bonds, as we note that 95% of the loans in **PAGLN**'s cover pool are interest only.

Though there are undoubtedly hurdles that would need to be addressed, **expanding the residential mortgage eligibility for HQLA Level 2b securitisations to include BTL collateral could encourage more BTL issuers to seek the *STS* label, and open up participation in BTL RMBS transactions to more bank treasury investors**. To date, the investor base of UK BTL RMBS deals has leaned more heavily towards asset managers, but with still healthy participation from bank treasuries despite the lack of *STS*-compliance, averaging 34% since 2019 and as much as 49-50% (across jurisdictions) in 2022/23. For comparison, distribution statistics for **PAGLN**'s covered bond indicate that bank treasuries were 65% of the buyer base, with asset managers allocated a further 31% of the bond. From a regulatory capital perspective, ***STS*-compliant UK BTL RMBS senior bonds already achieve the same 10% risk weight as UK benchmark covered bonds for UK investors under the ERBA and SSFA**. Thus, **we think that opening up the eligibility of BTL RMBS to be HQLA Level 2b would be an important step forward for the securitisation market in a manner that**

doesn't jeopardise the intent of the regulation. On the contrary, the success of **PAGLN**'s inaugural covered bond could encourage some current UK banks who are BTL RMBS issuers (particularly those that tend to issue senior-only transactions) to possibly follow in Paragon's footsteps, away from BTL RMBS.

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