Finance for People (No. 3) PLC, Asset-Backed Floating Rate Notes due 2013

UK - ABS

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TRANSACTION IN BRIEF

	Class A	Class B	Class C
Rating:	**Aaa**	**A2**	**Baa3**
Amount:	£210m	£70m	£20m
Coupon:	Libor +20 bp	Libor +55 bp	Libor +130 bp
Step Up Date:	Sep 2004	Sep 2004	Sep 2004
Step Up Margin:	Libor +50 bp	Libor +125 bp	Libor +300 bp
Final Maturity:	2013	2013	2013

Interest Payment Dates:	September, December, March and June (last business day)
Issuer:	Finance for People (No.3) PLC
Administrator:	Paragon Finance PLC
Administrator of Last Resort:	Barclays Bank PLC (**Aa2**, **Prime-1**)
Swap Counterparty:	Morgan Guaranty Trust Company of New York (**Aa3**, **Prime-1**)
Trustee:	Morgan Guaranty Trust Company of New York
Lead Manager:	J.P. Morgan Securities Ltd

Loan Characteristics

Type:	UK unsecured general purpose consumer loans, car finance and dealer stocking finance contracts.
Interest Rate:	Fixed.

Summary of Provisional Pool (30 April 1998)

	Universal	PPF	PCF
Count:	47,780	1,406	1,998
Prin. Amt:	£271,817,346	£8,735,785	£12,995,446
Average loan balance:	£5,689	£6,213	£6,504
Coupons (WA):	19.39%	20.0%	15.0%
Original Term (WA):	83.9 months	68.9 months	46.0 months
Remaining Term (WA):	80.3 months	64.2 months	43.3 months
Seasoning (WA):	30.3 months	4.2 months	2.6 months
Arrears (>1 month)	26%	6.5%	2.5%

Concentration (all loans):	24.0% SE, 9.7% Scot, 9.5% NW, 8.7% W Mid, 8.0% Yorks, 7.9% SW, 6.7% E Mid, 5.8% North, 5.4% Ldn, 5.3% Wales, 4.5% E Anglia, 0.9% N Ire, 3.6% Unallocated
Credit Support:	First Loss Fund (initially £7.125m). Overcollateralisation (initially £33m building up to £37.6m), that varies according to the arrears status of the assets. Class B and Class C Notes and Spread.
Closing Date:	16 June 1998

OPINION

Moody's has assigned a rating of **Aaa** to the £210,000,000 Class A Notes, a rating of **A2** to the £70,000,000 Class B Notes, and a rating of **Baa3** to the £20,000,000 Class C Notes (together the "Notes") issued by Finance for People (No. 3) PLC (the "Issuer").

The ratings of the Class A, Class B and Class C Notes are primarily based on an assessment of:

1. The quality of the receivables pool.
2. The level of protection against losses furnished by the first loss reserve, overcollateralisation within the structure, and any excess spread available to cover losses.
3. The relative positions in the priority of payments of the Class A, Class B, and Class C Notes.
4. The obligations of Morgan Guaranty Trust Company of New York (**Aa3**, **Prime-1**), as provider of the interest rate swaps and facility provider.
5. The legal and structural integrity of the structure.
6. The experience, expertise and creditworthiness of Paragon Finance PLC, ("PFPLC"), as credit manager.
7. The obligations of Barclays Bank PLC (**Aa2**, **Prime-1**) as standby credit manager.

Moody's rating on the Notes relates to the timely payment of interest and ultimate payment of principal.

The transaction represents the securitisation of unsecured personal loans, secured automobile loans and automobile dealer stocking finance, originated by Universal Credit Limited ("Universal"), Paragon Personal Finance Limited ("PPF"), Paragon Car Finance Limited ("PCF") and Paragon Dealer Finance Limited ("PDF").

The transaction includes a four year substitution period, as outlined in the "Collateral" section of this report.

Structure

The Issuer is a public company incorporated in England and a wholly owned subsidiary of the Paragon Group of Companies PLC.

The issuer funds the purchase of the loans by issuing the Class A, Class B and Class C Notes.

The initial balance of the First Loss Fund, the initial Overcollateralisation within the structure, and the up front transaction costs of the issuer are financed by the issuance of loan stock to, and a subordinated loan from, Paragon Finance PLC ("PFPLC"). These obligations are repayable by the Issuer though such payments are subordinated to payments of both interest and principal on the Notes.

Liquidity

The First Loss Fund acts as a source of liquidity for the structure and assists the payment of interest in the event that income from the receivables is insufficient to pay Note interest and various costs. The liquidity support provided by the First Loss Fund is increased by the fact that, replenishment of the First Loss Fund is senior to the reduction in the Principal Deficiency Ledger, until all Class A notes have been redeemed. In addition, if the First Loss Fund is empty, all receipts of principal by the issuer can be used to make interest payments to the Class A (but not Class B or Class C) Notes.

Interest Rate Risk

The receivables effectively[1] pay a fixed rate interest and the Notes pay floating rate interest based on LIBOR, and as a result, the Issuer has entered into hedging arrangements (including interest rate swap and cap agreements) to cover a significant portion of this risk.

1 Although many of the loans originated by Universal were documented as floating rate loans, the originator has traditionally not exercised its right to vary the rate. Moody's believes that any increase in the charging rate could lead to borrower resistance or to increased delinquency levels. The transaction contains provisions restricting Paragon's ability to vary these interest rates.

These arrangements differ from a normal securitisation in that the swap (the largest component of the hedging arrangements) follows a pre-set amortisation path. If the receivables underlying the transaction amortise at a different rate, the Issuer may either have to pay or receive partial termination payments under the swap. This risk is mitigated in a number of ways.

1. The pre-set amortisation path of the swap is set so as to overestimate the expected amortisation rate of the receivables, thus provides a degree of protection again faster than expected prepayments. In addition, the deal would also benefit from any prepayment penalties charged to borrowers. Although Moody's analysis of the transaction did not directly rely on any such receipts in the transaction cashflows, their possible presence did reduce our concerns regarding the interest rate mis-match in the structure.
2. The Issuer must also purchase interest rate caps to top up the hedging arrangements, thus limiting the risk of under-hedging. Under hedging is also reduced by the fact that any interest earned on the investment of principal prepayments will effectively be a variable rate income.
3. A requirement for the Issuer to enter into new hedging contracts so as to restore compliance with the hedging methodology on a quarterly basis if the transaction is to continue substituting assets. This includes the revision of existing hedging contracts to match the actual prepayments of the existing assets, as well as the provision of hedging contracts for any new receivables.

The principal balance of loans to be hedged (under both the swap and caps) is calculated by reference to a "Schedule" that projects the future outstanding balance of the receivables (less the current PDL provisioning policy outlined in the credit enhancement section of this report) on a contractual basis (i.e. allowing for scheduled amortisation, but assuming zero prepayments). At issuance the starting point of the schedule approximately equals the amount of the Notes issued.

The swap agreements cover a proportion of this Schedule. The proportion equals 90% of the balance for the next three months of the deal, and 1% less on a compounded basis for each month thereafter so that it equals 90% of the current balance for months one to three, 89.1% in month four etc.

The amount of the Caps available in each future time period is sized to ensure that the balance of the Swap and the Caps together comprise at least 80% of the balance of the Schedule.

This process leaves a certain amount of interest rate risk within the transaction, largely arising from the risk of termination payments under the swap, the possibility of over or under hedging, and the risk that those receivables with the highest implicit interest rates may amortise first. This is covered to a level consistent with the ratings assigned to the Notes by the Credit Enhancement (including excess spread) in the structure.

The initial swap and cap at the start of the transaction were set at 6.8%, providing initial gross spread levels (prior to the margin on the Notes and other Issuer expenses), of approximately 12.6% on the Universal loans, 13.2% on the Paragon consumer loans, and 8.2% on the automobile receivables.

The Issuer must enter into new swap and cap transactions, at the then market rate, in order to purchase further loans from the Paragon Group of companies (including Universal which was re-branded as PPF in October 1998). The weighted average interest rate of these further loans must be, for consumer loans at least 10%, and form auto loans at least 5%, higher than the rate payable by the Issuer on the swap (or such other figure as Moody's may confirm would not adversely affect the rating of the Notes). There are no such hedging requirements in relation to Portfolio Dealer Stocking Vehicle Contracts (which are not to exceed £5 million).

Consumer Credit Act and Set-Off Risks

Many of the initial portfolio of Universal loans would appear to have originated in a manner that was not fully compliant with the provisions of the Consumer Credit Act 1974. In these cases the loan agreement may be unenforceable without the leave of the court. Although these weaknesses would appear to be somewhat more prevalent in the Universal loans than in other transactions that Moody's has reviewed, they are rarely pursued by borrowers. Moody's has also reviewed legal opinions that indicate that while there is some additional risk to the transaction, most of the breaches are of a technical nature and that the courts rarely refuse to enforce such contracts.

Many of the receivables in the portfolio also constitute debtor-creditor-supplier agreements under Section 75 of the Consumer Credit Act. Under the Act, a creditor may become liable for breach of contract by the supplier of goods or services if the creditor advanced funds in the knowledge that they were to be used to finance the purchase. Examples include automobile loans, timeshare loans, or loans where the borrowers purchased death, disability, unemployment or other insurance along with the loan. In this event, borrowers may have the ability to claim against the originator, (and possibly the Issuer), or to set-off claims against payments due under the loan contracts. In addition a borrower may be able to set off a claim arising under a loan that has not been securitised against any obligations of that borrower that are part of the securitised pool.

Although Paragon Finance PLC ("PFPLC") has agreed to repurchase loans which prove to be unenforceable due to the Act, or which are subject to set-off, repurchases from the initial portfolio in respect of loans which are unenforceable due to the Act are subject to a floor of £1m and a cap of £20m. This cap and floor does not however apply to any automobile receivables and any substituted asset. In addition, giving of notice of the transfer of the receivables to the Issuer to the underlying borrowers prevents new set-off claims from arising. Notification can be triggered by a number of factors including the insolvency of various Paragon companies.

Collateral and Substitution

The portfolio can be divided into four broad categories.

1. Unsecured consumer loans originated by Universal Credit.
2. Unsecured Consumer loans originated by PPF.
3. Car finance contracts (hire purchase, contract purchase schemes and leasing contracts) originated by PCF.
4. Dealer Stocking Vehicle Contracts originated by PDF (available for substitution, though not included in the initial portfolio).

Moody's believes that the Universal Credit section of the portfolio is of relatively poor quality, as it includes substantially all of the receivables owned by Universal Credit, irrespective of their arrears status. Some 28% of the £271 million loans in the provisional pool falling into this category were more than 1 month in arrears, including almost 9% where the loans were more than 12 months in arrears. In addition, this section of the portfolio contained the greatest degree of non compliance with the Consumer Credit Act, as outlined in the relevant section of this report. Finally, the data available on this section of the portfolio was also less than that available on loans originated by Paragon companies.

Moody's also believes that the Dealer Stocking agreements may be relatively risky assets for the Issuer. Although the expected loss on these contracts is low, Moody's notes that the Issuer may have exposures to individual dealers of up to £500,000 and that there is some risk that the agreements may be re-characterised as secured loans to the dealer, and that the Issuer would not therefore enjoy ownership rights in the vehicles financed.

The Issuer may purchase substitute loans from the various Paragon entities (including Universal Credit) on any business day on or before the fourth anniversary of the closing date.

Further loans are conditional on a number of criteria being met, including limits on the value of Portfolio Car Finance Products (which, including Dealer Stocking Vehicle Contracts are not to exceed 12.5% of the aggregate current balance of the portfolio assets) and Portfolio Dealer Stocking Vehicle Contracts (not to exceed £5,000,000). This transaction also contains a provision preventing substitution if the Issuer is aware that the purchase would adversely affect the rating of the Notes, and a further provision requiring positive confirmation form Moody's of the rating should the Issuer wish to purchase additional assets while it has an outstanding balance on the Principal Deficiency Ledger.

The four year substitution period adds to the risk in the transaction, though this risk is reduced by the relatively strong historic performance of loans originated in the consumer lending business of the Paragon group. Moody's analysis therefore assumes some improvement in the quality of the asset portfolio over time, as the mix of the assets in portfolio changes over time, and the lending and servicing practices of Universal Credit is changed. In addition, the worst performing section of the Universal book are the so called "Flexiloans" granted to tenants rather than homeowners – origination of this product ceased in February 1997.

Credit Enhancement

Moody's has compared the expected performance of the receivables in a variety of severe economic scenarios with the credit enhancement and liquidity available to cover losses and arrears.

The first layer of protection is the *"Spread"* in the transaction, which is the difference between the interest earned on the account balances, and implicit within the receivables, less amounts payable on the Notes, and in respect of the various ongoing expenses. The value of the ongoing Spread was assessed under a variety of adverse conditions that would minimise its availability, including high prepayment speeds, various loss distributions, high arrears levels and changes in the average yield on the receivables contracts over time. Spread that is not used within each interest period, is not trapped within the structure. Spread is however, used to cover losses from previous periods and to fill the Spread trap and replenish both the First Loss Fund and the Overcollateralisation to their target levels before it can be released from the structure.

Given the yield available on the receivables, this Spread provides a powerful source of enhancement for the structure.

The second layer of protection for investors is the *Overcollateralisation* and *Spread Trapping* provisions of the transaction, as approximately £333 million of receivables or cash (excluding the First Loss Fund) support £300 million of Notes. The first £4.6 million of excess spread that would otherwise leave the transaction is used to increase the overcollateralisation to the initial target level of £37.6 million.

The target level of overcollateralisation within the structure is re-calculated each quarter according to the performance of the pool. The target level on each such calculation date is the sum of £4.6 million plus a provisioning policy that makes increasingly severe partial provisions according to the number of months that a loan is in arrears. Loans are 100% provided for within this mechanism when they are 12 monthly payments overdue. This process is based on the payments due from the borrower at the date of the acquisition by the issuer of that loan, thus reducing the ability of the servicer to dilute the effect of the provisioning policy by rescheduling loans.

Although Moody's believes that the partial provisioning level at each stage of arrears does not necessarily match the risk profile of these loans, we do believe that this ongoing provisioning policy very substantially increases the value of the Spread within the transaction, as Spread that might otherwise leave the structure is instead used to cover potential future reductions in cashflow.

The third layer of protection for investors in the rated Notes is the *First Loss Fund,* of £7.125 million. The target balance of this fund is not reduced while any of the Notes are outstanding.

The Class B Notes and Class C Notes also provide protection for the Class A Notes.

On each payment date on the Notes, interest on the Class A Notes is paid in priority to payment of interest to the Class B Notes, and both are paid in priority to interest on the Class C Notes.

If outstanding principal losses and partial provisions and any interest arrears on the Notes, after the effect of spread, exceed the First Loss Fund plus the Class B and Class C Note balance, then the payment of Class B and Class C Note interest is subordinated to the rebuilding of the First Loss Fund and to the reduction of the principal deficiency ledger. Class B and Class C interest is therefore effectively subordinate to A Note interest and principal but not Class B and Class C principal.

No principal is paid to the Class B and Class C Noteholders until the Class B and Class C Notes together represent approximately 60% of the total Class A, Class B and Class C Notes. Thereafter, and subject to certain triggers, prepayments are allocated so as to restore the 60% ratio. Principal payments allocated to the Class B and Class C Notes are divided in proportion to their respective original principal balances. The Class B and Class C Notes are subject to a minimum balance of £11,000,000 while any Class A Notes remain outstanding.

Servicer

PFPLC is the servicer for the transaction. As of 28 February 1999 PFPLC employed approximately 600 staff in administering a mortgage portfolio of approximately £11 billion for the Paragon Group and associated securitisation vehicles. Paragon also has entered the consumer loan business in 1997 and as at the 28 Feb 1999, administered portfolio of approximately £390 million, including loans serviced for third parties. Moody's believes that Paragon has a well developed servicing business with a track record of successful collections and arrears management in the United Kingdom.

Barclays Bank PLC (**Aa2**) is the servicer of last resort.