European Structured Finance
New Issue

First Flexible No.1 plc

Ratings

£276,000,000 Class A Notes................AAA
£24,000,000 Class B Notes.................A

Analysts

Stephanie Mathern
44 20 7417 6299
smathern@fitchibca.com

Kenneth W. Gill
44 20 7417 6272
kgill@fitchibca.com

Company Contacts

First Active Financial U.K.
Tony Ward
44 1372 737 601
tony.ward@firstactive.co.uk

Chris Higgins
44 1372 737 864
chris.higgins@firstactive.co.uk

Lead Manager

JP Morgan
Colin Evans
44 20 7325 8920

Insa Adena
44 20 7325 4324

Tim Van den Brande
44 171 325 9258

■ Summary

First Flexible No. 1 plc's £300 million mortgage-backed notes are rated as listed at left. First Flexible is the first issue of notes backed by a pool of UK flexible residential mortgages originated by First Active Financial plc (FAF). The issuer is a special purpose company incorporated and registered in England and Wales with limited liability as a public limited company.

The expected ratings are based on the quality of the collateral, available credit enhancement, FAF's mortgage underwriting and servicing capabilities, and the transaction's sound legal and financial structures. Credit enhancement totalling 10% at closing is provided by the class B notes (8%) and the £6 million reserve account (2%); the reserve account supports the class B notes.

At closing, the issuer acquired a portfolio of residential mortgages from FAF, which forms the collateral for the notes. The portfolio consists of first-ranking fixed- and floating-rate mortgage loans secured by residential property located in England and Wales.

To determine appropriate credit enhancement levels, Fitch IBCA analysed the collateral using its UK housing recession default model as a benchmark and adjusted it to account for the unique risks associated with the flexible mortgage product. Fitch IBCA also modelled the cash flow contribution from excess spread using stress scenarios indicated by the default model. The cash flow test showed that each class of rated notes could withstand loan losses at a level corresponding to the related stress scenario without incurring any principal loss or interest shortfall.

■ Strengths

- Low loan-to-value (LTV) mortgages relative to other UK transactions.
- Capable servicer.

■ Concerns

- Primary obligation of issuer to fund potential net redraws.
- New product (limited historical performance data).

■ Collateral

Mortgage Pool

The provisional pool forming the collateral for the notes consists of 4,711 mortgage loans with a total outstanding balance of £300 million. The mortgages represent first ranking liens securing loans originated by FAF. The majority of the pool (92%) is flexible mortgages *(see Flexible Mortgages, page 2)*. Characteristics of the provisional pool are listed on the following page.

Key Information

Issuer: First Flexible No.1 plc

Originator: First Active Financial plc

Trustee: Citicorp Trustee Co. Ltd.

Servicer: The Mortgage Corp.

Provisional Pool Cut Date: 30 Sept. 1999

Swap and Cap Provider: Morgan Guaranty Trust Co. of New York

Interest Payments: Monthly, beginning 31 Jan. 2000

Coupon Step-Up Date: November 2006

Legal Maturity: November 2031

Expected Maturity: November 2006

Collateral: First-ranking residential mortgage loans secured by real property located in the UK

The mortgages in the pool are of several repayment types. Capital and interest and interest-only repayment are the most common, making up 44% and 36% of the pool, respectively. Endowment and pension mortgages constitute 20% of the pool.

The geographic concentration of the pool is diverse, with 24% in the North, 18% in Greater London, and 14% in each of the Southeast and Southwest regions (Fitch IBCA's regional definitions may vary from those presented in the transaction's offering circular).

There is a small portion (5%) of fixed-rate loans, all of which will reset to variable-rate by July 2001. There are also capped variable-rate mortgages in the pool with capped rates in effect until, at the latest, March 2002. The interest rate risk associated with such mortgage products is addressed in the Credit Issues section at right.

Currently, none of the mortgages being securitised are in arrears. With a flexible mortgage (described above right) the borrower has the flexibility to prepay a scheduled payment, thereby allowing him to either redraw up to his scheduled balance or take a payment holiday (subject to agreement with FAF) without being considered in arrears.

Provisional Pool Characteristics
(£)

Aggregate Drawn Balance	300,232,996
Aggregate Undrawn Balance	37,633,887
Average Scheduled Principal Balance	71,719
Average Actual Principal Balance	63,730
Average Undrawn Portion	7,989
Loan-to-Value Ratio Based on Scheduled Principal Balance (%)	63.37
Loan-to-Value Ratio Based on Actual Principal Balance (%)	59.88
Weighted Average Interest Rate (%)	6.75
Weighted Average Seasoning (Mos.)	15

Flexible Mortgages

The flexible mortgage is a new mortgage product in the marketplace that gives borrowers the flexibility to prepay a portion of their principal balance at any time (monthly, annually, etc.). Borrowers may use the amount prepaid as a line of credit, which they can redraw on at any point in the future. The general limitations, however, include that the amount outstanding cannot exceed the loan's scheduled balance and if the borrower prepays more than 20% (the threshold amount) of the scheduled principal balance, a fee of 1% annually (commitment fee) will be charged on amounts in excess of the threshold. The borrower may reschedule his loan to avoid such penalties; however, the redraw would then not be available for such rescheduled amounts. In most cases, and for all newly originated loans, FAF holds the right to change both the commitment fee and the threshold level with 60 days' prior notice. However, pursuant to transaction documentation, they must maintain 20% as the maximum threshold and 1% as the minimum commitment fee.

■ Credit Issues

Fitch IBCA has analysed the collateral for First Flexible by subjecting the mortgage loans to stresses resulting from an assessment of historical home price movements and mortgage defaults in the UK. This study shows that the borrower's LTV, by reflecting the size of the borrower's down-payment and willingness to pay, and debt-to-income ratio (DTI) or income multiple, by reflecting the borrower's ability to pay, are the key determinants of default probability in the UK.

Affordability Factors

FAF advances loans to borrowers according to the income multiple affordability measure. An income multiple gives an indication of the size of the mortgage compared to a borrower's annual salary. FAF lending guidelines permit up to 3.25 times (x) the primary income plus the secondary income or 2.75x the joint income *(some discretion can be used in the underwriting process; see Origination and Servicing, page 5)*.

Fitch IBCA's model factors in affordability to calculate overall credit enhancement. Base default probabilities are determined by using a matrix that considers each loan's affordability factor (in this case, income multiple) and LTV. The matrix classifies affordability into five classes, the lowest of which (class 1) encompasses loans with income multiples less than 2.0 and the highest of which (class 5) encompasses all loans with income multiples exceeding 3.0. Generally, a weighted average income multiple of 2.5, which, if each loan had this characteristic, would equate to a base default probability ranging from 6%–44%, depending on LTV.

Loan-to-Value Ratios

As mentioned, the weighted average LTV for the provisional pool is lower than average for a UK mortgage pool. This can be explained by the borrower profile for the flexible type mortgage. Borrowers who take out a flexible mortgage are, in most cases, not first-time buyers and, thus, typically do not need as much leverage. In this pool, 67% of the loans are remortgages, illustrating that many borrowers refinance into a flexible mortgage after experiencing a build up of equity in their homes. The flexible mortgage then allows borrowers to obtain a line of credit for expenditures such as renovations or consumer goods.

The overall default probability of the provisional pool is driven by the LTV. For example, a loan with an LTV of 64% (the pool's average, using the scheduled principal balance, which includes both drawn and undrawn portions of the loan) and an income multiple of 2.84 (the pool's average), the resulting base default probability is 13%. Base default probabilities are assigned on a loan-by-loan basis and then aggregated, weighted by current balance.

Interest Rate Risk

There are two types of interest rate risk present in this transaction: basis risk between FAF's standard variable rate (SVR) and the London Interbank Offered Rate (LIBOR) and the interest rate risk from fixed-rate and capped variable-rate mortgages. The financial structure of the transaction hedges these risks in the following ways.

To ensure that FAF's SVR maintains a minimum spread over LIBOR of 100 basis points, the servicer agrees to reset the SVR to such a rate as LIBOR fluctuates or will post cash to the transaction account in an amount equivalent to the difference between the SVR rate and LIBOR plus 100 basis points.

There is a swap in place to essentially convert the fixed rate loans to floating rate. The swap will be entered into at the outset of the transaction with swap counterparty, Morgan Guaranty Trust Co. of New York.

To protect the collateral cash flow in case LIBOR plus 100 basis points reaches the cap rates on the capped mortgages, the issuer, on the closing date, purchased a series of caps. The strikes on the caps purchased may not exactly match the cap rates on the mortgages, so the issuer established a hedge reserve. The amount of the hedge reserve is the amount of remaining exposure, which was known at the outset of the transaction.

Loss Severity

To estimate the loss severity on the loans in the reference portfolio, Fitch IBCA used its UK default study that examined home price movements in the different regions of the country. By focusing on the recession of the late 1980s–early 1990s, various stressed market value declines (MVDs) were estimated.

When calculating recovery value, Fitch IBCA's model reduces each property valuation by the MVD, repossession costs, and the cost of the servicer carrying the loan from delinquency through default.

Fitch IBCA increased the MVD assumptions for high value (jumbo) properties by 10–30%. Higher value properties are assumed to have larger market value declines owing to the smaller marketplace for these properties and less precise pricing information. Approximately 17% of the reference portfolio received jumbo loan "hits."

On the basis of worst case information gathered from UK mortgage lenders, Fitch IBCA assumes repossession costs represent 5% of the loan's balance at the time of possession. To calculate the carrying cost Fitch IBCA assumes that the borrower does not pay interest for a period of 18 months and that interest accrues during this period at the weighted average interest rate of the reference portfolio, which is 6.75%.

■ Financial Structure

To determine the soundness of the financial structure of the transaction, Fitch IBCA examined the redraw facility, the mechanics of the substitution period and the paydown structure of the notes.

Redraw Facility and Fund

A unique and crucial component to this transaction is the requirement for the issuing vehicle to fund borrower redraws throughout the life of the transaction. As prepayments grow, the redraw exposure of the transaction increases. On the other hand, redemptions will reduce the exposure to redraws since once a borrower redeems a portion of his mortgage, he may not redraw on that amount. A redraw facility and fund will be established at the outset of the transaction to provide a source of funding for future redraws. The redraw facility is a £45 million line of credit provided by Barclays Capital (rated 'F1+' by Fitch IBCA) for the life of the transaction, until 2031. The redraw fund, however, is a cash amount, £0.5 million, deposited up front, which can grow to a maximum amount of £3.0 million by trapping cash flow from the transaction. The amount of cash that is trapped varies according to the prepayment speed of the underlying collateral as higher levels of prepayments are expected to the redraw exposure.

Determining the appropriate sizing for the redraw facility and fund is a particular challenge due to the lack of historical data on flexible mortgage borrower behaviour. Fitch IBCA's methodology for determining the sufficiency of the redraw facility and fund was based on the following assumptions.

The risk in this transaction is that in any given period, redraws exceed prepayments (i.e. net redraws), hence the need for an external source of funding. It is somewhat unrealistic to assume that all borrowers will prepay their mortgage down to £1 and redraw the full amount all at the same time. Rather, it was assumed that borrowers will prepay and redraw at random, for the most part. The seller can control such random behaviour to some extent with the commitment fee. For the majority of flexible mortgages in the pool, the issuer has the right to increase the commitment fee and decrease the threshold, thereby creating a disincentive to prepaying, if necessary. The overall level of coverage for potential redraws required by Fitch IBCA varies depending on whether or not the lender has the ability to modify the terms of the commitment fee.

The redraw facility and fund serve as a backstop to the seller's control mechanism. Therefore, the size of the facility and fund need only cover a portion of the total potential redraws. A cash flow model was used to determine the potential exposure to redraws throughout the life of the transaction. The two key inputs to the model were prepayment speed and redemptions as a percentage of prepayments. The model showed that throughout the life of the transaction, given the aforementioned methodology, the maximum exposure would be £47.7 million. Funds necessary to cover this exposure first come from the redraw fund and then from the £45 million facility. Since the need for cash to cover redraws grows with prepayments, the fund may grow over time according to the speed of prepayment.

Substitution

The issuer will be able to purchase further mortgages during a three-year substitution period, which ends November 2002. During this period, further mortgages may be purchased only with funds coming from redemptions. The substitution period can terminate early at the option of the issuer or under certain conditions.

During the substitution period mortgages may be purchased by the issuer only if:

- The mortgage has been originated by FAF.
- The mortgage's maturity is not greater than 27 years.
- The borrower has been bound under contract to the 1% commitment fee and 20% threshold limit.
- The redraw exposure of the loan as a percentage of principal balance is not greater than the initial redraw exposure of the entire pool as a percentage of total initial principal balance.

Generally, the acquisition of further mortgages by the issuer is subject to the following conditions:

- The amount of further mortgages acquired in any period cannot exceed 3% of the balance of the pool at the time of purchase.
- The credit quality of the pool cannot fall by more than 0.25% as a result of the purchase of further mortgages.
- The amount of interest arrears on all further mortgages may not be more than 2% of total interest due on those mortgages during the prior 12 months.
- The principal deficiency balance of the transaction may not exceed 0.1% of the aggregate principal balance of the initial mortgage pool.
- No more than 25% of the available credit support for the class A notes has been used.
- No rating agency has notified the issuer that the purchase of further mortgages will cause a downgrade of the transaction.

Priority of Payments

The transaction will pay interest on both class A and B (unless there is a class B note trigger event) pro rata and then will pay principal on class A until the end of the class B lock-out period, which exists until the coupon step-up date and until the class B balance outstanding as a percentage of the total outstanding balance of the notes is at least twice its initial percentage. A class B trigger event will occur if there are class A notes outstanding and if a principal deficiency exists in an amount greater than the amount of class B principal outstanding. If such an event occurs, the structure will then pay down the interest and principal of class A before that of class B.

On each monthly payment date, the priority of payments will be as follows:

1. Trustee fees and associated cost.
2. Amounts due to the paying agent bank.
3. Expenses of the issuer.
4. Servicing fees.
5. Amounts payable to the swap counterparty, interest on the redraw facility, and interest on class A (pro rata and pari passu).
6. Subject to a class B note trigger event not occurring, interest on class B.
7. Credit the reserve fund up to its required amount.
8. To pay for the purchase by the issuer of redraws.
9. To repay all principal amounts outstanding under the redraw facility.
10. To credit the redraw fund up to its required amount.
11. To fund the purchase by the issuer of further advances up to the maximum amount.
12. During the substitution period only, to fund the purchase by the issuer of further mortgages (subject to the previously mentioned constraints).
13. To allocate any amounts applicable to redeeming the notes (principal of class A pays down sequentially first, and then pro rata when class B as a percentage of the outstanding note balance is at least two times its initial percentage).
14. If a class B note trigger event has occurred, to pay class B interest.

Provided that there is no principal deficiency and no event of default:

15. To pay amounts repayable to the servicer.
16. To pay interest on the start-up loan.
17. To pay principal on the start-up loan.
18. To pay deferred consideration to FAF.
19. To make dividend payments to shareholders of the issuer.

■ Credit Enhancement

The class B notes are subordinate to class A, thereby creating 8% in credit enhancement for the senior notes. The reserve fund also provides credit enhancement for classes A and B. The reserve fund has an initial balance of approximately £6 million, or 2.0% of the initial pool and remains as such for the life of the transaction. Fitch IBCA believes that these levels of credit enhancement are sufficient to support the expected ratings.

Reserve Fund and Hedge Reserve

The issuer is required to use funds from the reserve fund and the hedge reserve to pay certain liabilities to the noteholders if income received from mortgage loans is insufficient to cover such liabilities.

The reserve fund and hedge fund have been funded by a portion of the proceeds from the start-up loan. Amounts credited to the reserve fund will be available to meet income deficiencies, including interest shortfalls on the class A and B notes.

■ Origination and Servicing

FAF is an indirect wholly owned subsidiary of First Active plc, an Irish mortgage lender (former building society). Since its incorporation in 1986, FAF has focused on lending to a specific niche of the UK mortgage market by offering unique, rather than low-cost products.

Mortgages are originated via direct distribution centres and indirectly through a network of brokers. FAF also has an internet site as a growing source of originations. The underwriters at FAF have experience mostly from high street lenders. New hires follow a specific training/mentoring program after which they are gradually given increasing underwriting limits. Although the underwriters follow the underwriting guidelines established by FAF, they are allowed certain “discretion points” based on their seniority/experience.

In August 1996, First Active plc acquired The Mortgage Corp. (TMC), another centralised lender, with a portfolio of about £1.2 billion. Starting in July 1998, FAF repackaged TMC’s securitized portfolio via two “Tattenham” issues.

In acquiring TMC, FAF gained an experienced mortgage servicing operation. The systems developed at TMC are user-friendly and tailored specifically for securitisation purposes.

Since the TMC purchase, FAF has moved the servicing and origination operations to the same site in Epsom. Its servicing operations have been upgraded by hiring a team from a US financial services operations centre to increase work flow and telephone call efficiency.

The arrears management team is a separate group within servicing. Most mortgage payments are made via direct debit on the last business day of the month. If the direct debit fails, a notice goes to the borrower on the same day. If the payment does not clear on the second attempt it is automatically referred to the arrears department, which makes a phone call to the borrower. If the situation progresses to where two payments have been missed, legal action is considered and after three months of being in arrears, an order for possession of the property is executed.

After due diligence was performed on both FAF and TMC, Fitch IBCA determined that they are a capable origination and servicing operation.

■ Legal Structure

First Flexible is a public company incorporated under the laws of England and Wales. On the closing date, First Flexible will acquire the collateral from FAF. As security for the payments of all moneys payable with respect to the notes, First Flexible will enter into a deed of charge, creating the security in favour of the trustee. The security includes first mortgages and first fixed charges in favour of the trustee on all the issuer's rights, claims, title, benefit, and interest in and to the underlying collateral.

The transaction's structure was designed to ensure that a seller insolvency would not interrupt the timely payments of principal and interest to investors. The loan sellers assign their right, title, and interest in and to the mortgages to the trustee. There is no recourse to the loan sellers as the sellers of the mortgages, such that the transfer is treated as a true sale and the mortgages were removed from the loan sellers' balance sheets.

The mortgage sale agreement contains representations and warranties given by the originators in relation to the pool of mortgages. No search of title will be conducted by the issuer or the trustee; rather, they will rely on the above-mentioned representations and warranties. If there is an unremediable breach of any of the representations or warranties, the relevant seller will be required to repurchase the loan(s) in question.