European Structured Finance
New Issue

First Flexible No. 2 plc

Ratings

GBP 276,000,000
Class A Notes……………………..AAA
GBP 24,000,000
Class B Notes……………………….....A

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■ Summary

First Flexible No.2 plc's GBP300 million mortgage-backed notes are rated as indicated at left. First Flexible No. 2 is the second issue of notes backed by a pool of UK residential mortgages originated by First Active Financial UK (FAF). The issuer is a special purpose company incorporated and registered in England and Wales with limited liability as a public limited company.

The ratings are based on the quality of the collateral, available credit enhancement, First Active's mortgage underwriting and servicing capabilities, and the sound legal and financial structure of the transaction. Credit enhancement totalling 9.75% at closing was provided by the class B notes (8.00%) and the reserve account of GBP5.25 million (1.75%) that supports the B notes. The size of the reserve account will increase through excess spread to a maximum of GBP7.50 million (2.50%) giving a total level of credit enhancement of (10.50%) assuming no amortisation.

At closing, the issuer acquired a portfolio of residential mortgages from FAF, which formed the collateral for the notes. The portfolio consisted of first-ranking fixed and floating rate mortgage loans secured by residential property located in the United Kingdom. The residential mortgages in the reference pool were exclusively provided for the purpose of purchasing investment, or buy-to-let, property.

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.

■ Collateral

At closing, the pool forming the collateral for the notes consisted of 4,418 mortgage loans with a total outstanding balance of GBP 296,117,093. The mortgages represented first ranking liens securing loans originated by FAF. The pool was entirely composed of investment home loans. The majority of the pool (87%) were flexible mortgages comprised of drawn and undrawn amounts of the mortgage (see Flexible Mortgages below).

Key Information

Issuer: First Flexible No.2 plc

Originator: First Active Financial UK (FAF)

Trustee: Citicorp Trustee Company Limited

Servicer: The Mortgage Corporation (TMC)

Provisional Pool Cut Date: April 30, 2000

Cash Flow Swap Provider: Morgan Guaranty Trust Company of New York (rated)

Redraw Facility and GIC Provider: Barclay's Bank plc (rated F-1+ by Fitch)

Interest Payments: Monthly beginning July 1, 2000

Coupon Step-up Date: July 2006

Legal Maturity:2032

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

The mortgages in the pool were of several repayment types. Interest only and capital and interest repayment were the most common, making up 53% and 41% of the pool respectively. Endowment and pension mortgages comprised 6% of the pool.

The geographic concentration of the pool was primarily in London and the South East, with 59% in London and Outer Metro and 10% in the South East (Fitch IBCA's regional definitions may differ from those described in the offering circular).

There was a large portion (59%) of fixed rate loans, all of which will reset by 2009. There were also capped variable rate mortgages in the pool with capped rates in effect until at the latest, 2004. The interest rate risk associated with such mortgage products is addressed in Credit Issues, on page 3.

At closing none of the mortgages being securitised was more than 30 days in arrears. With a flexible mortgage (described below) the borrower has the flexibility to prepay a scheduled payment, thereby giving the option to skip a payment without being considered in arrears. However, such a 'Payment Holiday' has to be agreed with First Active Financial.

Key Characteristics of Provisional Pool

Aggregate Drawn Balance	GBP296,117,093
Aggregate Undrawn Balance	GBP10,653,997
Avg scheduled principal balance	GBP67,025
Avg actual principal balance	GBP69,436
Avg undrawn portion	GBP2,411
Loan-to-Value (LTV) Ratio	72.1%
Loan-to-Value (LTV) Ratio (inc. undrawn)	73.5%
Wtd Avg Seasoning	15.0 months

Flexible Mortgages

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

■ Credit Issues

The properties in the provisional pool were largely single-family units, either flats or houses, rather than multifamily properties (i.e. blocks of flats). Therefore, Fitch IBCA analysed the pool using its UK housing study. This study shows that the borrower's LTV, reflecting the size of their down-payment and willingness to pay, and debt-to-income (DTI) ratio or income multiple, reflecting their ability to pay, are the key determinants of default probability in the UK. Fitch IBCA then made adjustments to these assumptions to account for the investment home loan product as follows.

Affordability Factors

For the investment home loan, FAF advances loans to borrowers primarily according to rental yield. This measured as the monthly estimated rent over the monthly mortgage payment, which FAF requires to be at least 125%. An affordability measure such as an income multiple, while calculated for most applicants, is used only as a secondary check in the underwriting process. The weighted average rental cover for the pool was in reality over 180%.

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 of 6-44% depending on LTV.

Based on a combined rental yield/income multiple approach to underwriting, Fitch IBCA assumed borrowers fall in between class 4 and 5.

Loan-To-Value Ratios

As mentioned earlier, the weighted average LTV for the provisional pool was lower than average for a UK mortgage pool. This was, in part, due to a maximum underwritten LTV of 85% subject to discretion imposed by FAF. Also, the profile of the typical investment property borrower is of one that has extra funds available to invest, and thus can afford to make a significant downpayment.

The overall default probability of the provisional pool was driven by the LTV. For example, on a loan with an LTV of 73% (the pool's average) and an income multiple of 2.75 (the pool's average), the resulting base default probability was 17%. Such probabilities were 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: the interest rate risk from fixed rate and capped variable rate mortgages, and basis risk between FAF's standard variable rate (SVR), 3 month Libor on 3 month Libor linked mortgages and 1 month LIBOR. The financial structure of the transaction hedges these risks in the following ways.
There is a swap in place to, essentially, convert the fixed rate loans to floating rate. The swap was entered into at the outset of the transaction with swap counterparty, Morgan Guaranty Trust Company of New York (ratings).

To protect the collateral cashflow in case LIBOR reaches the cap rates on the capped mortgages, the issuer from 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 equal to the amount of remaining exposure, which was known at the outset of the transaction.

To ensure that FAF's SVR maintains a minimum spread over 1 month LIBOR of 120 basis points, the servicer agreed 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 1 month Libor + 120 basis points.

To hedge the basis risk beween 3 month Libor on the loans in the pool and 1 month Libor which is paid out to noteholders, the Issuer also entered into a basis swap with the swap counterparty.

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 '80s-early '90s, various stressed market value declines (MVDs) were estimated.
When calculating recovery value, Fitch IBCA's model reduced each property valuation by the MVD, repossession costs and those of the servicer carrying the loan from delinquency through default.

Fitch IBCA increased the MVD assumptions for high value ('jumbo') properties by 10-30%. Such properties are assumed to have larger market value declines owing to their smaller marketplace and less precise pricing information. Approximately 15% of the reference portfolio received jumbo loan 'hits'.

On the basis of worst case information gathered from UK mortgage lenders, Fitch IBCA assumed repossession costs represent 5% of the loan's balance at the time of possession. To calculate the carrying cost, Fitch IBCA assumed 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 was 7.51%

■ 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

A unique and crucial component to this transaction was the requirement for the issuing vehicle to fund borrower redraws throughout the life of the transaction. To enable it to do so, a redraw facility was established at the outset of the transaction to provide a source of funding for future redraws. The redraw facility is a GBP27 million line of credit provided by Barclays Capital (rated F1+ by Fitch IBCA) for the life of the transaction, until 2032.

Determining the appropriate sizing for the redraw facility was 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 was based on the following assumptions.

The risk in this transaction was 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 GBP1 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 varied depending on whether or not the lender has the ability to modify the terms of the commitment fee.

The redraw facility serves as a backstop to the seller's control mechanism. Therefore, the facility need only be sized to cover a portion of the total potential redraws. Initially, the balance of flexible mortgages in the pool was GBP257 million, so the redraw facility provided coverage for approximately 10% of that exposure.

A cashflow model was used to determine the exact 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. As prepayments grow, the redraw exposure of the transaction increases. On the other hand, redemptions reduce the exposure to redraws since once a borrower redeems a portion of his mortgage, he may not redraw on that amount.

The model showed that throughout the life of the transaction, given the above mentioned assumptions, the maximum exposure would be GBP27 million.

Substitution

The issuer is able to purchase further mortgages during a three-year substitution period that ends July 2003. During this period, no principal is paid to noteholders. The substitution period can terminate early only if notes fall under enforcement.
During the substitution period mortgages may be purchased by the issuer only if:

- The mortgage has been originated by FAF
- The mortgage is not capped or fixed rate
- 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 redraw exposure of the entire pool as a percentage of total principal balance on the previous payment date

Generally, throughout the life of the transaction, the acquisition of further mortgages by the issuer is subject to the following conditions:
- The amount of further mortgages cannot exceed 3% of the balance of the pool at the time of purchase
- 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 amount of arrears of value over £100 does not exceed 2.5% of the aggregate principal balance of the mortgage pool at the time
- The principal deficiency balance of the transaction may not exceed 0.1% of the aggregate principal balance of the initial mortgage pool
- No rating agency has notified the issuer that the purchase of further mortgages will cause a downgrade of the transaction
- The weighted average LTV of the mortgages prior to the purchase of further mortgages does not exceed the weighted average LTV of the initial pool by more than 1%

Priority of Payments

The transaction pays interest on both class A and class B (unless there is a B note trigger event) consecutively, and then will pay principal on class A and B (unless there is a B note trigger event). 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 paydown the interest and principal of class A before that of class B.

Principal repayment of the Class B notes is locked out until 5 years after the end of the substitution period unless the Class A notes have been redeemed in full. At the end of the Class B principal lock out period *pro rata* principal repayment of the A and B notes will occur if , on each payment date, the current level of credit enhancement to class A is at least twice its initial level at closing. In addition to this requirement, there must be no more than 2.5% of the principal outstanding of loans in arrears to allow a *pro rata* paydown to continue. If the above conditions are not met, the priority of payments will revert to sequential.

On each annual payment date, the priority of payments pre-enforcement 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, the redraw facility, and interest on class A (*pro rata* and *pari passu*)
6. Subject to a B note trigger event not occurring, interest on class B
7. Credit the reserve fund up to its required amount
8. Pay for the purchase by the issuer of redraws
9. To repay all principal amounts outstanding under the redraw facility
10. If a liquidity trigger event occurs to credit the liquidity reserve to the amount of the difference between the reserve fund percentage and 3%.
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
14. If a B note trigger event has occurred, to pay class B interest

And 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 8.00% in credit enhancement for the senior notes. The reserve fund also provides credit enhancement for classes A and B. It had an initial balance of approximately GBP5.25 million or 1.75% of the initial pool, and builds up to GBP7.50 million through excess spread. The build up is expected to occur linearly in the first year. Fitch

IBCA believes that these levels of credit enhancement are sufficient to support the assigned 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 and hedge funds are funded by a portion of the proceeds from the start-up loan. Amounts credited to the reserve fund are available to meet income deficiencies, including interest shortfalls on the class A and B notes, as well as principal deficiencies arising from time to time.

■ Origination and Servicing

First Active Financial plc is an indirect wholly-owned subsidiary of First Active plc, an Irish mortgage lender (former building society). Since its incorporation in 1986, First Active Financial 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 generally have experience 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 guidelines established by FAF, they are allowed certain ‘discretion points’ based on their seniority/experience.

In August 1996, First Active plc acquired The Mortgage Corporation (TMC), another centralised lender, with a portfolio of about GBP1.2 billion. Starting in July 1998, FAF began to repackage and securitise TMC’s portfolio via two ‘Tattenham’ issues. TMC and The Mortgage Trust Limited acquired in 1994 were renamed First Active Financial plc in 1998.

In acquiring TMC, First Active plc gained an experienced mortgage servicing operation. The systems developed at TMC are tailored specifically for securitisation purposes.

Since the TMC purchase, FAF has moved its servicing and origination operations to the same site in Epsom. Its servicing operations have been upgraded in its hiring a team from a US financial services operations centre to increase workflow and telephone call efficiency. By cross training staff, TMC is able to resolve potential arrears sooner.

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.

After one month in arrears, an independent rent receiver will be appointed to collect the rental income due on a loan and pay it directly to the mortgage account. The rent receiver is able serve notice and foreclose on the property upon a continuation of shortfall in rental income. However, the rent receiver does not take the property into possession nor accept the liabilities of the landlord. At any time prior to notice being served, the landlord has the ability to make good the shortfall in rental yield. If further attempts to resolve the arrears fail, the foreclosure process begins at the end of the tenants’ lease (in most assured shorthold tenancies, this is a maximum of six months). Given the ability to impose a rent receivership and because the property occupants are tenants and not owners, the process of foreclosure in tenanted residential property is quicker than for owner-occupied.

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 No.2 is a public company incorporated under the laws of England and Wales. On the closing date, it acquired the collateral from FAF. As security for the payments of all monies payable with respect to the notes, First Flexible entered into a deed of charge, creating the security in favour of the trustee. The security included 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 assigned their right, title, and interest in and to the mortgages to the trustee. There was no recourse to the loan sellers as the sellers of the mortgages, such that the transfer was 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.