

# Paragon Mortgages No.1 PLC, Multi Class Mortgage-Backed FRNs

UK - MBS

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**TRANSACTION IN BRIEF**

	<b>Class A</b>	<b>Class B</b>
Rating:	<b>Aaa</b>	<b>A1</b>
Amount:	£168,000,000	£17,000,000
Coupon:	LIBOR + 28 bps	LIBOR + 80 bps
Step Up Date:	July 2004	July 2004
Step Up Margin:	56 bps	160 bps
Final Maturity:	Oct 2030	Oct 2041
Interest Payment Dates:	15th day in July, October, January, April	
Issuer:	Paragon Mortgages (No.1) PLC	
Originator:	Paragon Mortgages Limited	
Servicer:	Paragon Finance PLC	
Servicer of Last Resort:	Guardian Mortgage Services Limited	
Trustee:	Citicorp Trustee Company Limited	
Lead Manager:	JP Morgan Securities Ltd.	
Asset Characteristics:	First residential mortgages to individuals and corporates in England, Wales and Scotland	

**Summary of Provisional Pool (as at 30 April 1999)**

Count:	3,147 residential loans
Prin. Amt:	£156,686,000
LTV:	Avg: 68.9%; 90-95%: 0.3%; 95-100%: 0.6%; 100+%: 0%
Loan Size:	Avg: £49,000; Max: £500,000
Performance:	<b>Current</b> (inc <=1 month arrears) 99.4% <b>Arrears:</b> 1-3 months 0.6%; 3-6 months 0%; 6+ months 0.03%
Loan Usage:	Purchase 48.2%, Remortgage 51.8%
Interest Rate:	Paragon Variable Rate 33.2%; Capped 10%; LIBOR-linked 1.5%; Fixed Rate 55.3%
Concentration:	North 2.4%; N.West 5.2%; Yorks 8.9%; E.Midlands 3.7%; W.Midlands 5.9%; E.Anglia 2.8%; S.East 33.9%; S.West 8.7%; G.London 24.2%; Wales 2.9%; Scot 1.6%
Seasoning:	1998 50%, 1999 49.9%
Mtg. Indem. Ins:	C.E. Heath (Lloyd's of London) (£5,045,813 of the portfolio is covered by MIG insurance)
Credit Support:	First Loss Fund (2.5% of the initial balance of the mortgages and the Pre-Funding Reserve), the Class B Notes and Excess Spread
Launch Date:	4 June 1999



## **RATING OPINION**

Moody's has assigned long-term credit ratings of **Aaa** to the Class A Notes and **A1** to the Class B Notes of the Issuer.

The rating of the Class A Notes is based upon an analysis of the characteristics of the mortgage pool backing the Notes, the protection the Notes receive from credit enhancement against defaults and arrears in the mortgage pool, and the legal and structural integrity of the issue.

The ratings of the Class B Notes are based on the above factors, and on an assessment of the extent of their subordinate position within the structure.

The ratings of each of the Notes address the timely payment of interest, and ultimate payment of principal.

## **Structure**

### ***Purchase of Mortgage Loans***

The Issuer used the Note proceeds:

1. To purchase a portfolio of UK residential mortgage loans originated by Paragon Mortgages Limited (PML);
2. To make a loan to Paragon Mortgages (No.2) SA (PSA2), an insolvency remote special purpose company incorporated in Luxembourg, which in turn purchased a further portfolio of UK residential mortgage originated by PML;
3. In funding the initial balance of the Pre-Funding Reserve, which is a reserve fund to be used to purchase further mortgage loans up to 30 September 1999.

The Issuer utilised the proceeds of a subordinated loan from Paragon Finance PLC (PFPLC) to meet the start-up costs and to fund the £4.6M First Loss Fund.

The mortgage loans purchased by PSA2 are mortgage loans made to corporates and the purpose of the PSA2 loan structure is to eliminate the potential imposition of UK withholding tax that would otherwise fall due on payments to the Issuer from corporate borrowers had it purchased the loans directly. Borrowers are able to rely on the UK/Luxembourg double tax treaty to remove the need to withhold on payments under the loans. Under Luxembourg law, payments by PSA2 under the loan back into the UK to the Issuer can be made free from withholding. Moody's is concerned that this arrangement could be attacked on anti-avoidance grounds by either the UK or Luxembourg tax authorities, but is satisfied that these risks are sufficiently mitigated by the following:

1. Advice has been given by the transaction's accountants that the amount of the withholding would be limited to 20% of the interest payable with respect to 15.71% (the proportion of corporate loans in the deal) of the portfolio balance, which amounts would ultimately be recoverable from the UK revenue by the Issuer. Accordingly, the impact of an imposition of withholding tax would be of a liquidity rather than a credit nature;
2. The same advice also confirms that, if UK withholding tax was to be imposed, the UK Revenue would have recourse to the related borrower and not against the Issuer should it attempt to recover amounts that should have been withheld as the obligation to withhold is an obligation of the borrower; and
3. Paragon and its advisors have discussed the arrangement with the UK tax authorities and, whilst a definitive sign-off has not yet been achieved, it would appear that the UK tax authorities are positive (although until formal clearance is given, borrowers remain under an obligation to withhold).

PSA2 has created security over all its assets in favour of the Issuer as security for the repayment of the loan made to PSA2. The Issuer has also created fixed and floating security over all its assets including the mortgage loans purchased directly by it, and its rights under the loan made to PSA2 and the security granted to it by PSA2. Opinions in relevant jurisdictions confirm the validity of these arrangements.

## **Ownership of Issuer**

The Issuer is a special purpose vehicle incorporated in England ultimately owned by The Paragon Group of Companies PLC and SPV Management (an independent provider of services to securitised transactions). Typically, UK MBS transactions rated by Moody's have featured an orphan SPV as issuer. The fact that the Issuer is not an orphan company introduces additional risks not typically found in UK MBS transactions:

- As a matter of UK tax law, it is possible that a subsidiary can be fixed with liabilities for tax of another member of its group. In this case, an extensive range of undertakings provides assurance that the chance of such secondary liabilities arising is remote.
- A company organised in the UK can be wound up by a shareholders' resolution. Whilst, in the circumstances, there might be little advantage to be gained by a liquidator of the Issuer's parent company by doing this, Moody's stress scenarios envisage such an attempt being made. Moody's is, however, satisfied that the combination of the non-petition covenants given by the parent companies in the Paragon group, and the share ownership structure of the Issuer, effectively eliminate this risk.

## **VAT Grouping**

In common with other Paragon transactions rated by Moody's (see the previous "Finance For People" deals), but unlike the vast majority of UK MBS transactions, the Issuer is grouped with the rest of the Paragon Group for VAT purposes. The VAT grouping means that services or goods provided between members of the VAT group are not subject to VAT (which would otherwise be payable on servicing fees); but, as a consequence, each member of the VAT group is jointly and severally liable for VAT liabilities of all other members of that group. A long standing arrangement is in place to mitigate this risk:

1. A Trust Account, held in the name of Morgan Guaranty Trust Company of New York (**Aa3, Prime-1**) (MGT) as trustee with National Westminster Bank Plc (**Aa2, Prime-1**), can be used by any member of the VAT group to meet group VAT liabilities should PFPLC (which, as representative member, is primarily liable for group VAT) fail to do so. PFPLC must maintain a minimum balance in the Trust Account equal to the greater of (1) £120,000, (2) 1.2 times the actual VAT liability for the Paragon VAT Group in the last two accounting periods, or (3) 1.2 times the sum of the estimated VAT liabilities of the Paragon VAT Group for the current and next succeeding accounting periods.
2. If PFPLC fails to pay VAT due by it, or fails to maintain the minimum balance in the Trust Account, the Issuer will automatically be de-grouped; on a degrouping, no new VAT liabilities will arise but any that exist remain. The VAT authority cannot prevent a company from de-grouping, but it must be given 90 days' prior notice.
3. If de-grouping were to occur, the administration fees payable by the issuer are in any event expressed to be VAT inclusive.

PSA2 is not a member of the Paragon VAT Group.

## **Collateral**

The assets backing the structure are loans to individuals and corporates located in England, Wales, and Scotland secured by first ranking mortgages over residential properties situated in England, Wales and Scotland. All mortgages were originated by PML.

This is the first public transaction of its kind rated by Moody's which includes residential loans made to corporate borrowers. These loans are in the main buy to let loans made to "professional landlords"

Although a number of the products in the Paragon pool (such as the self employed products and the buy to let products) are now increasingly being offered by other Prime lenders on a greater scale, Moody's believes that these products can be more volatile in adverse economic environments. The pool credit quality was negatively affected by:

1. The proportion of buy-to-let mortgages (approximately 87.5%) in the pool;
2. The proportion of non-commodity products (e.g. Freshstart mortgages – 4.3%; Shared Ownership mortgages – 2%) in the pool;
3. 64% of the loans having been made to self-employed borrowers; and
4. A degree of collateral concentration in the South East (33.9%) and in Greater London (24.2%).

Moody's believes that these factors are addressed by the relatively strong performance of similar loans previously originated by PML, the low LTV's in the pool, and by the amount of credit enhancement present in the structure.

In addition, a small percentage of the loans (approximately 3.2% of the pool) have the benefit of Mortgage Indemnity policies provided by Lloyd's of London through C.E.Heath. (A substantial element of this policy is re-insured on a cut through basis by highly rated entities.) The loans covered by the MIG policy are those loans (other than Share Ownership loans, Right-to-Buy loans and Buy-to-Let loans) with an LTV in excess of 75%.

## **Credit Enhancement**

Investors in the Notes are protected from the effect of credit losses on the pool in a number of ways.

### ***Excess Spread and the MMR***

The first layer of protection for investors in the Notes is the Excess Spread in the transaction which is the difference between:

1. The income receivable by the Issuer under the mortgage loans and its other investments and swap arrangements; and
2. The amounts of interest due by the Issuer on account of its various ongoing costs and expenses and under the Notes and swap arrangements.

Excess Spread is to be applied by the Issuer first in increasing the First Loss Fund to the required amount, and then in reduction of any principal deficiencies that have arisen following a principal loss on any of the loans. (Such losses are recorded on the Principal Deficiency Ledger, which is a ledger maintained for this specific purpose.)

The transaction benefits from a Minimum Mortgage Rate (MMR) which provides some guarantee as to the amount of Excess Spread that will be available; under the MMR, the Administrator must set the rate on the variable rate mortgages in the portfolio so as to ensure that the weighted average interest of the portfolio taken as a whole is at least a specified margin in excess of the Libor rate applicable to the Notes. The specified margin starts at 1.60%, and becomes 2% after July 2004 (although there is an option for the Issuer to borrow further amounts under the subordinated loan made by PFPLC so as to cover the shortfall that would result absent the MMR.)

However, the credit enhancement value of the MMR, and the Excess Spread that it generates, depends on a number of factors such as relative prepayment speeds of the various loan types in the portfolio; should the variable rate loans (including the Libor-linked loans), which make up 34.7% of the portfolio, prepay more quickly, then the portfolio would be dependent on an increasingly small number of variable loans generating sufficient revenue to cover any shortfall arising with respect to other loan-types (such as fixed and capped rate loans) in the portfolio. Moody's has analysed the likelihood of adverse prepayment speeds and is satisfied that the residual risk is consistent with the rating levels, especially given that the majority of fixed and capped rate mortgage loans revert to a variable rate after a fixed initial period of up to 5 years.

The credit enhancement value of Excess Spread also depends on the timing of principal losses. Excess Spread is available on a "use it or lose it" basis and so, if not used to top up the First Loss Fund or to reduce the Principal Deficiencies Ledger, it is paid back to PFPLC via the Subordinated Loan and other profit extraction mechanisms; which might occur before losses on the portfolio have shown through. The value of the Excess Spread was assessed by Moody's under a variety of adverse conditions.

### ***First Loss Fund***

The second layer of protection for investors in the Notes is the First Loss Fund (equal to 2.5% of the initial current balance of the portfolio and the Pre-Funding Reserve (see below)). This fund is available to pay interest and senior cost obligations of the Issuer should there be insufficient spread on the assets to meet these obligations. The fund is topped up, in priority to the elimination of any principal deficiencies on the Principal Deficiency Ledger until all the Class A Notes are redeemed, using Excess Spread. After July 2004, the required bal-

ance of the First Loss Fund may amortise in line with the mortgage collateral so that it equals 5% of the current principal balance of the outstanding mortgage pool, but only if (a) there is no debit balance on the PDL, and (b) less than 8% of the pool by principal balance is more than 3 months' in arrears. Moody's believes that these are very strict tests to meet.

### ***Principal Subordination***

The third layer of protection for investors is the subordination of the principal balance of the B Notes to the A Notes which arises by virtue of the sequential redemption of the Notes. The Notes can redeem pro rata with the Class B Notes after 5 years but only if:

1. The ratio of Class B Notes to Class B Notes and Class A Notes is at least twice the ratio calculated as at closing;
2. There is no debit balance on the PDL;
3. Less than 22% of the pool by principal balance is 3 or more months in arrears; and
4. Pro rata redemption would not cause the principal balance of the Class B Notes to fall below £8.5M.

### ***Interest/Interest Subordination***

Further protection is provided via the subordination of interest due under the Notes; on each interest payment date, all income (after paying certain senior costs and expenses) is allocated first to pay Class A interest and then Class B interest.

### ***Interest/Principal Subordination***

In addition, in certain circumstances, Class B Note interest is subordinated to payment of principal under the Class A Notes. This occurs where outstanding principal losses and any interest arrears on the Class A Notes (after the effect of spread) exceed the First Loss Fund plus the Class B Note balance; in this circumstance, payment of Class B interest is subordinated to the topping-up of the First Loss Fund and to the reduction of the PDL. Class B interest is therefore effectively subordinate to A Note interest and principal but not Class B principal.

### ***Liquidity***

Several levels of protection are available to investors to counter the effect of temporary shortfall in cashflows from the loans caused by delinquencies in the pool or any interruption in the servicing functions or cash collection functions.

### ***Principal Paying Interest***

The Issuer has the ability to use principal receipts under the mortgage loans to meet its senior expenses obligations and interest due under the Class A Notes (but not the Class B Notes). This provides substantial protection for investors in the Class A Notes against a gradual deterioration in the arrears performance of the portfolio. Moody's believes, however, that the fact that the Issuer is unable to use principal receipts to pay the Class B Notes exposes the Class B Notes to greater liquidity risk than is common in UK MBS.

### ***First Loss Fund***

As described above, the First Loss Fund is available to cover interest shortfalls under the Notes. The value of the liquidity support provided by the First Loss Fund is increased by the fact that the First Loss Fund is topped-up prior to payments being made to investors in respect of any PDL balances that may arise within the structure, and replenishment of the First Loss Fund ranks ahead of the reduction of any outstanding Principal Deficiency Ledger. The availability of the First Loss Fund to pay Class B Note interest is, however, limited in the manner described in "Interest/Principal Subordination" above.

### ***Liquidity Facility***

The Issuer does not have the benefit of a separate liquidity facility. Moody's believes that the First Loss Fund, which is topped-up from Excess Spread before Excess Spread is applied in reduction of the PDL, provides adequate liquidity support for the transaction.

## Pre-Funding

Part of the proceeds of the Notes has been retained by the Issuer and will be used to purchase further mortgage loans, and/or to make further advances under the Luxembourg Loan to allow PSA2 to purchase further loans, on or prior to 30 September 1999. However, before further loans can be included within the transaction in this way, Moody's must confirm its ratings of the Notes. Any amounts that are retained for Pre-Funding will, to the extent not applied in the purchase of further loans, be applied in redemption of the Notes on 15 October 1999, which is the first Interest Payment Date.

## Accrued Interest

The Issuer purchased all loans made to individuals which were "current" as at the closing date at par. Loans which were not current and which are loans to individuals (ie those sold direct to the issuer) were, however, sold at par plus the amount of all interest and arrears as at the purchase date. PSA2 purchased all loans which are loans to corporates at par plus the amount of all interest and arrears as at the purchase date. (Any further purchases made by the Issuer and PSA2 using Pre-Funding proceeds will be calculated in the same way). The transaction structure provides for this to be repaid as follows: each payment received under such a loan will be treated as first representing the accrued interest or arrears and used to redeem the Notes. Whilst this mechanism results in temporary under-collateralisation of the Notes, it is a term of the transaction that, should the rate at which such interest and arrears amounts are collected fall below Moody's expectations, Moody's may specify that the First Loss Fund is to be increased to a higher amount in order to mitigate this risk.

## Collections and Bank Accounts

The vast majority of payments under the Loans are collected by PML under the direct debit scheme. All receipts in respect of the loans will be paid directly into the PML collection account, and will be held on trust for the Issuer or PSA2 pending transfer into the transaction account of the Issuer or PSA2 as appropriate. These transaction accounts are dedicated accounts of the Issuer and PSA2 held with National Westminster Bank Plc (**Aa2, Prime-1**). Cash in the transaction accounts must be invested by PFPLC as administrator in eligible investments which meet certain criteria, including a requirement that the investments are rated either **Aaa** or **Prime-1** and mature prior to the next interest payment date.

## Interest Rate Risk

The mortgage loans either charge interest at a variable rate set by PML (33.2% of the pool), or by reference to 3 month LIBOR (1.54% of the pool) or at a (temporarily) fixed or capped rate (65.3% of the pool), whereas payments under the Notes are to be calculated by reference to 3-month sterling LIBOR. The MMR mechanism described above partially mitigates this risk because it ensures that weighted average rate under the mortgage loans exceeds LIBOR under the Notes plus the relevant margins. However, as mentioned above, the protection afforded by this mechanism is susceptible to a number of factors such as relative prepayment speeds of the various loan types in the portfolio.

In order to further mitigate interest rate, the structure also benefits from interest rate swaps and caps provided by Morgan Guaranty Trust Company of New York (**Aa3, Prime-1**) in respect of the fixed and capped rate mortgages. The swap may require the Issuer to pay certain break costs to the swap provider in the event that mortgages default or prepay, but payments of these amounts is deeply subordinated.

The Issuer is also obliged to enter into suitable arrangements with respect to the hedging of further fixed rate or capped rate loans acquired subsequently via the Pre-Funding mechanism or as a result of conversion (see below).

## Conversion

The Servicer may alter the payment method between repayment and interest only and may also convert fixed rate into floating rate mortgages and vice versa. However, there are pre-conditions to any conversion between interest charging methods; for example, if required to maintain the ratings on the Notes, appropriate hedging must be in place.



## Further Advances

The Issuer may use principal receipts from the mortgage portfolio to make further advances to the mortgage borrowers, but the cumulative amount of further advances is subject to a cap of £20m, and is also conditional on the Issuer's continued compliance with various contractual restrictions contained in the transaction documents. In addition, if Moody's indicates to the Issuer that the making of additional Further Advances will result in a downgrade of the Notes, then, unless the First Loss Fund is increased to a level such that Moody's confirms the ratings of the Notes will not be downgraded if additional Further Advances were to be made, the Issuer will no longer be entitled to make Further Advances.

## Servicing

PFPLC is the servicer for the transaction. PFPLC currently employs approximately 365 staff in originating and administering a mortgage portfolio of approximately £1.1 bn for the Paragon Group and associated securitisation vehicles. Paragon also has entered the consumer loan business in 1997 and administers a £368m portfolio. 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.

Guardian Mortgage Services Limited (GMS), a wholly owned subsidiary of Guardian Royal Exchange PLC (**A1, Prime-1**), is the servicer of last resort. In the event that PFPLC is no longer servicing the portfolio, GMS will, if a successor has not been located, assume the responsibility of servicing the mortgage portfolio.

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