Paragon Mortgages (No.18) PLC

Presale

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Analysts

Tulika Oommen
+44 20 3530 1390
tulika.oommen@fitchratings.com

Shomas Kayani
+44 20 3530 1006
shomas.kayani@fitchratings.com

Surveillance
Grace Yeo
+44 20 3530 1486
grace.yeo@fitchratings.com

Operational Risk Group
Robbie Sargent
+44 20 3530 1404
robbie.sargent@fitchratings.com

Capital Structure

Class	Expected Rating	Outlook	Amount (GBPm)	CE[c] (%)	Final Maturity	TT[a] (%)	TTLM[b]
A	AAAsf	Stable	TBD	15.75	Mar 2041	TBD	TBD
B	AAsf	Stable	TBD	10.00	Mar 2041	TBD	TBD
C	Asf	Stable	TBD	5.00	Mar 2041	TBD	TBD
D	NR	n.a.	TBD	n.a.	Mar 2041	n.a.	n.a.
Total Issuance			TBD				

Expected ratings do not reflect final ratings and are based on information provided by the issuer as of 09 September 2013. These expected ratings are contingent on final documents conforming to information already received
[a] Tranche thickness percentage - ratio of class size to collateral balance
[b] Tranche thickness loss multiple - TT% divided by Fitch's base case loss expectation. See also *Structured Finance Tranche Thickness Metrics*, 29 July 2011
[c] Credit enhancement – The actual credit enhancement could be different from that modelled and the final capital structure will be assessed before assigning final ratings.

Transaction Summary

Fitch Ratings has assigned expected ratings to the notes to be issued by Paragon Mortgages (No.18) PLC (PM18), an SPV incorporated in England and Wales. The final pool of loans backing the notes will consist solely of prime buy-to-let (BTL) residential mortgages originated in England and Wales by Paragon Mortgages (2010) Limited (Paragon), a wholly owned company of Paragon Group plc.

The ratings are based on Fitch's assessment of the underlying collateral, available credit enhancement (CE), Paragon's origination and underwriting procedures, the servicing capabilities of Paragon Finance plc (as delegated by the administrator, Paragon), and the transactions' financial and legal structure.

Key Rating Drivers

Prime BTL Portfolio: This is a prime BTL portfolio with a weighted average (WA) seasoning of 3 months, a WA original LTV (OLTV) of 72.7%, an indexed WA current LTV (CLTV) of 72.5% and a WA interest-coverage-ratio (ICR) of 81.5%. The proportion of loans concentrated in London, Outer Metropolitan and the South East is 56.3%.

Paragon Performance: The portfolio consists entirely of BTL loans and Fitch continues to stress the portfolio's default rates beyond those of a prime owner-occupier portfolio at all rating levels, despite the fact historically the Paragon series has been one of the better performing BTL series. The series continues to perform robustly with low arrears and defaults; three month plus arrears are below 75bp for the entire series as of March 2013. This was factored into Fitch's rating analysis.

Libor Linked Products: The transaction has a high percentage of LIBOR-linked loan products (60.3%) and loans that revert to a LIBOR-linked product (38.1%) in comparison with previous Paragon transactions that had a high percentage of standard variable rate loan products. Since the notes are also paying LIBOR, there is less uncertainty regarding the amount of future excess spread in this deal than in past deals, which Fitch has accounted for in its cash flow analysis.

Counterparty Rating Trigger Risks: The rating triggers for the issuer account bank, qualified investments, collection account bank and derivative counterparties in the transaction documents have specific reference to Fitch criteria. This creates a degree of uncertainty regarding future counterparty arrangements (see *Counterparty Risk* below for further details) but Fitch does not expect this mechanism to negatively affect note ratings so long as the administrator maintains counterparties that are consistent with Fitch's counterparty criteria.

Key Parties

Issuer: Paragon Mortgages (No.18) plc

Originator: Paragon Mortgages (2010) Limited

Seller: Paragon Mortgages (2010) Limited

Servicers: Paragon Finance plc (as delegated by the administrator, Paragon Mortgages (2010) Limited

Back-up Servicer: Homeloan Management Limited (RPS2)

Administrator: Paragon Mortgages (2010) Limited

Trustee: Citicorp Trustee Company Limited

Subordinated Lender: Paragon Finance PLC

Transaction Account Bank: National Westminster Bank plc (A/Stable/F1)

Collection Account: Barclays Bank plc (A/Stable/F1)

Principal Paying Agent: Citibank, N.A., London Branch (A/Stable/F1)

Swap Providers: Macquarie Bank Limited, London Branch (A/Stable/F1) and Lloyds TSB Bank plc (A/Stable/F1)

Arrangers: Lloyds TSB Bank plc and Macquarie Bank Limited, London Branch

Joint Lead Managers: Lloyds TSB Bank plc**,** Macquarie Bank Limited and Morgan Stanley & Co. International plc

Related Criteria (additional related criteria and research can be found on page 13)

Counterparty Criteria for Structured Finance and Covered Bonds, May 2012

Rating Sensitivity[1]

This section of the report provides an insight into the model-implied rating sensitivities to hypothetical changes in defaults and/or recoveries on the assets in a stressed environment. These increased defaults and/or recoveries on assets are relative to the dynamic weighted average frequency of foreclosure (WAFF) of the mortgage portfolio (22.6% for the ‘AAAsf’ rating scenario) and the dynamic weighted average recovery rate (WARR) of the mortgage pool (47.9% for the ‘AAAsf’ rating scenario), respectively; they are assumed to occur immediately after closing of the transaction. The model-implied rating sensitivities, based on such assumptions, are only indicative of some of the potential outcomes and do not consider other risk factors to which the transaction is exposed.

Rating Sensitivity to Defaults

	Class A	Class B	Class C
Original rating	AAAsf	AAsf	Asf
15% increase in default rates	AAAsf	AAsf	Asf
30% increase in default rates	AA+sf	AA-sf	Asf

Source: Fitch

Rating Sensitivity to Recovery Rates

	Class A	Class B	Class C
Original rating	AAAsf	AAsf	Asf
15% decrease in recovery rates	AAAsf	AAsf	Asf
30% decrease in recovery rates	AAAsf	AA-sf	Asf

Source: Fitch

Rating Sensitivity to Shifts in Multiple Factors

	Class A	Class B	Class C
Original rating	AAAsf	AAsf	Asf
15% increase in default rates, 15% decrease in recovery rates	AA+sf	AA-sf	Asf
30% increase in default rates, 30% decrease in recovery rates	AAsf	A+sf	BBB+sf

Source: Fitch

Model, Criteria Application and Data Adequacy

Fitch analyses the collateral for UK residential transactions using a country-specific, loan-by-loan mortgage default model. The model subjects the mortgage loans to stresses based on Fitch’s assessment of historical house price movements and mortgage defaults in the UK. The agency’s study showed that a borrower’s loan-to-value ratio (LTV), reflecting the size of their down-payment and their willingness to pay, and a borrower’s debt-to-income (DTI) ratio or income multiple, reflecting their ability to pay, to be the key determinants of default probability in the UK.

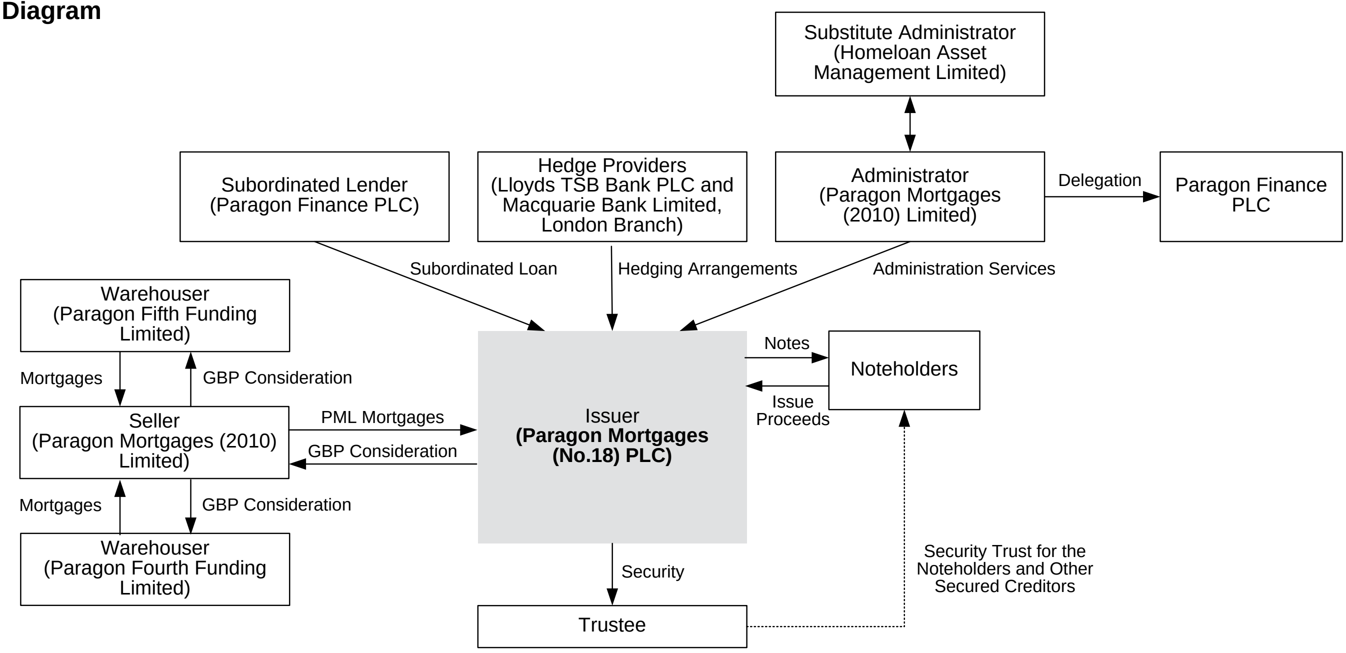
Paragon provided Fitch with a loan-by-loan data template and a number of key data fields were missing or partially completed. Paragon was unable to provide Fitch with borrowers’ county court judgement (CCJ), prior bankruptcy order (BO), individual voluntary arrangements (IVA) details or prior mortgage arrears history before the date of loan origination. Fitch assumed that 2% of the pool consists of loans with adverse credit and consequently increased the default probabilities of these loans.

The collateral review of the mortgage portfolio involved reviewing loan-by-loan loss severity information on the originator’s sold repossessions between 2001 and 2013, during which the agency determined the originator’s experienced loss severity rate and quick sale discount (QSA). The QSA calculated using data provided by the originators was 32% which is higher than Fitch’s base criteria assumption of 22%; the agency increased the QSA assumption to 32% to reflect this data.

[1] These sensitivities only describe the model-implied impact of a change in one of the input variables. This is designed to provide information about the sensitivity of the rating to model assumptions. It should not be used as an indicator of possible future performance

Figure 1

Structure Diagram



Source: Transaction documents

In addition a visit was conducted at Paragon's offices to assess their underwriting and servicing procedures in September 2012. Fitch also conducted a file review of a sample of loan files. The review focused on the underwriting procedures conducted by Paragon compared to Paragon's credit policy at the time of underwriting. The review showed no material discrepancies in the underwriting practices of Paragon.

Fitch considers that the data available for the analysis is of good quality.

To determine the levels of credit enhancement needed to support the ratings, Fitch simulated the transaction's cash flows using a model incorporating its cash flow stresses.

Transaction and Legal Structure

Legal Framework

On or about the closing date, the seller will assign the rights, title and interest in and to the mortgages to PM18 (a public company incorporated under the laws of England and Wales). There will be no recourse to the sellers (except with respect to loans sold in breach of warranty) so that the transfer to PM18 is treated as a true sale.

At closing, PM18 will enter into a deed of charge, creating security over its assets in favour of the trustee as security for all payments under the notes. The security will include first-ranking sub-mortgages and first-ranking fixed charges in favour of the trustee over all the issuer's rights, claims, title, benefit and interest in and to the underlying collateral.

The transaction structure is designed to ensure that seller insolvency would not interrupt the timely payment of principal and interest on the notes to investors. The sellers will assign their rights, title and interests in and to the mortgages to the issuer. There will be no recourse to either Paragon as the seller of the mortgages; the transfers are treated as a true sale.

Representations and Warranties

The mortgage sale agreement contains representations and warranties given by the originators in relation to the pool of mortgages. No search of title has been conducted by the issuer or the trustee; rather they have relied on such representations and warranties. If there is an irremediable breach of any of the representations or warranties, the seller will be required to repurchase the loan(s) in question.

Specifically, the representations and warranties include the following:

- Each mortgage is secured on a freehold or leasehold residential, or mixed commercial/residential property situated in England or Wales.
- No lien or right of set-off exists between the mortgagee and any borrower.
- No mortgage is or will be repayable later than [28 February 2039].
- as at the relevant purchase date, the maximum aggregate principal amount of all arrears mortgages which may be purchased by the issuer is GBP1,000,000.

Further Advances

Discretionary further advances may be agreed and advanced to borrowers in the pool by, and at the discretion of, the administrator (acting on behalf of the issuer) using principal receipts or recoveries, provided that, among others:

- there was no debit balance on the principal deficiency ledger (PDL) as at the previous interest payment date;
- the reserve fund is at its required amount;
- the WA current LTV of the portfolio would not exceed its value by more than 1% after utilising the pre-funding;
- arrears over three months do not exceed 2% of the then-outstanding balance of the pool;
- each of the mortgage condition tests was satisfied;
- minimum interest rate for discretionary further advances is three-month Sterling Libor, or Bank of England Base Rate (as applicable), plus 4.25%.

Disclaimer

For the avoidance of doubt, Fitch relies, in its credit analysis, on legal and/or tax opinions provided by transaction counsel. As Fitch has always made clear, Fitch does not provide legal and/or tax advice or confirm that the legal and/or tax opinions or any other transaction documents or any transaction structures are sufficient for any purpose. The disclaimer at the foot of this report makes it clear that this report does not constitute legal, tax and/or structuring advice from Fitch, and should not be used or interpreted as legal, tax and/or structuring advice from Fitch. Should readers of this report need legal, tax and/or structuring advice, they are urged to contact relevant advisers in the relevant jurisdictions.

Asset Analysis

Lender Adjustment

Fitch's base default probabilities assume that origination, underwriting and servicing practices and procedures are in line with those of a standard traditional UK mortgage lender with market expertise, financial stability and relevant management experience.

As part of the analysis, the agency performs an operational review of the originator to assess the origination, underwriting and servicing capabilities of the seller. As a result of this review, if Fitch believes that origination, underwriting and servicing procedures are below market standards, an adjustment to the base default probabilities of the whole portfolio is warranted. The relevance of this adjustment is further sized by considering certain elements that cannot be factored into the analysis on a loan-by-loan basis, either because they are not available or because they are only applicable on an aggregate basis.

As a mortgage company, Paragon specialises in the origination of BTL products through intermediaries, and since February 2001 the vast majority of originations have been to professional BTL investors. To qualify for the benefits of such a loan a borrower must already possess a portfolio of at least three properties and must present a minimum of two years financial accounts for the underwriters to scrutinise. Such professional BTL investors are typically characterised as individuals who earn a substantial portion of their income from the rental yield on their portfolio; indeed, some may rely entirely on this source of income for their livelihood.

For new originations, the rental income from single, self-contained properties must be a minimum of 125% of the mortgage payment calculated on an interest only basis, at either the product rate, or a reference rate of 5%; whichever is the higher. The rental income for all other property types must be a minimum rental income of 130% of the mortgage payment calculated on an interest only basis, at either the product rate, or the reference rate of 7%; whichever is the higher.

Fitch has considered several strengths and concerns in its lender adjustment (see also *Appendix B - Origination, Underwriting and Servicing*).

Among others, the main concerns are as follows: (1) Paragon is a niche market lender and this market has decreased over the last several years. Demand for such products could result in an acceptance of lesser quality loans or applications being agreed or received, however this can be mitigated by the low arrears levels evidenced; (2) only intermediary business is accepted as Paragon does not have a high street presence, although this is mitigated by the quality and experience of intermediaries on the robustly controlled panel.

In Fitch's view, strengths to consider are as follows: (1) Paragon has an excellent track record with very low levels of arrears and this is assisted by a thorough understanding and application of the receiver of rent policy; (2) affordability is stressed significantly over the current pay rate; (3) all mortgage applications require a full valuation.

It is also important to note that despite the recent increase in mortgage origination the volumes are still considerably below those seen pre-2008 and it is still difficult for certain buyers to secure mortgages due to tight lending criteria and high deposit requirements for better deals. This has, and quite possibly will for the foreseeable future, cause a number of borrowers to remain in their current rental agreement(s) thus increasing the demand for rental properties. This will, and has, seen an increase in revenues for professional landlords and reduced the arrears rates in BTL securitisations. Potential interest rate rises will be the biggest single risk factor to these loans.

Buy-To-Let

Fitch considers loans on BTL properties to be inherently more susceptible to default than those secured on an owner-occupied property because:

- the property is not the borrower's prime residence and so the borrower may be more likely to default on the loan during a time of financial stress; and,
- the servicing of the loan is primarily dependent on rental income, which may be more volatile in stress periods than personal income.

In addition, landlord borrowers may target particular regions or groups of tenants within their portfolios, which may lead to a concentration of similar properties in a similar location at the individual borrower level.

One important mitigating feature of BTL loans is that, upon default, the foreclosure process is quicker than for owner occupied properties, as tenants with short-hold tenancy agreements can generally be more easily evicted than owner-occupiers, while the repossession process through the courts is shorter.

In addition, Fitch has noted that a high proportion of the borrowers in this pool are professional landlords, with a minimum of 24 months' experience of managing at least three properties and with a recognised aptitude for enforcing tenancy contracts. The remaining BTL borrowers are private investor landlords, also with significant experience who aim to stay in the market long term.

Professional landlords are believed to be more adept at managing a portfolio of properties, monitoring and acting on economic conditions and market indicators, reducing downtimes between tenancies, and selecting tenant types and target locations than standard borrowers. This assertion is based on the time and energy that professional landlords are able to spend administering their portfolio and researching the market.

For BTL properties a receiver of rent process (ROR) can be used to manage repossessed properties. Following the appointment, the ROR directly collects rent from paying tenants and passes it to the lender to pay down any arrears. This helps maintain the rental income stream and thus keep a steady flow of cash to the transaction.

Interest-Only Loans

93.6% of the loans in the pool are interest only, which is typically the loan-vehicle favoured by BTL borrowers.

Interest-only loans can be construed to be riskier than amortising loans because of the greater risk that the borrower may be unable to repay the debt in full at maturity (i.e. balloon payment risk). However, interest-only hits will ordinarily not apply to BTL products as the BTL market is almost entirely interest-only which is factored into the general BTL product adjustments.

The risk in this transaction is further mitigated by the fact that the borrowers are predominantly professional landlords with a demonstrated ability to manage a property with an interest-only loan, and given the strong historic performance on previous Paragon transactions.

In light of the mitigants above no adjustment has been made to interest-only loans in this pool.

Concentration Risk

Paragon's business model targets professional landlords who typically have a number of BTL loans with Paragon and if one landlord has a number of loans in the pool, each one not large in itself, the total exposure could become significant.

Fitch considers the level of concentration in the transaction's mortgage portfolio to be a key factor in the assessment of tail risk within a particular transaction.

Receiver of Rent (ROR)

Fitch believes the risk of exposure to a borrower is mitigated to a large extent by Paragon's reliance on the ROR process. If Paragon believes a borrower is struggling it will appoint a ROR on the entire portfolio of the borrower, which does not require court approval. They will send a surveyor with a property agent to the property and inform the tenant that they will have to send their rent to the ROR, who forwards it on to Paragon, instead of paying the landlord and no monies from that point onwards are allowed to be passed on to the borrower. Any payments received in excess of monthly mortgage payments are used to prepay the loans. Where the property is vacant a locksmith is assigned to change the locks on the property while a decision is made as to whether the property should be rented or sold.

This is a process Paragon initiates early on (typically within two months) as part of a pro-active approach to monitoring and managing arrears. Paragon holds discussions with borrowers, who have been identified as struggling to keep up with payments, regarding their current financial situation and then assess their ability to continue managing the property effectively.

Even if a borrower becomes current at a later date, Paragon is not obliged to release the property back to the borrower, which could effectively force a borrower to redeem all the mortgages with Paragon.

Self-Employed Borrowers

54.9% of borrowers in this pool are self-employed. These are typically professional landlords who rely solely on rental income for their earnings. Given the demonstrated ability of professional landlords to manage a property (based on the previous performance of Paragon transactions) no adjustment has been made for borrowers designated as self-employed in this pool.

Illiquid Properties

20.7% of the loans in this portfolio fall into Fitch's jumbo and small categories, which represent property values at the less liquid ends of the property market.

Historical portfolio performance in most countries typically shows that high-value and low-value properties tend to realise higher than average relative losses, even in times of low stress in the housing market.

Where a property value is classified as high or low, Fitch will reduce the distressed property value after deduction of the MVD by an incremental illiquidity adjustment factor. These illiquidity adjustment factors are derived by rating scenario, with a larger haircut applied to the distressed

Quick Sale Adjustment

The Market Value Decline (MVD), which reflects Fitch's view of each region's vulnerability to house price declines, and reflects historical experience and socioeconomic factors, also incorporates a QSA. This is the discount a seller is likely to have to suffer for selling a property in a depressed market; often reflecting non-marketable conditions. Professional landlords also tend to modify properties in order to maximise rental yields which can affect the market value of the properties or use additional revenue to undo such modifications when it comes to a sale. Fitch's base QSA is the same across all regions and rating scenarios.

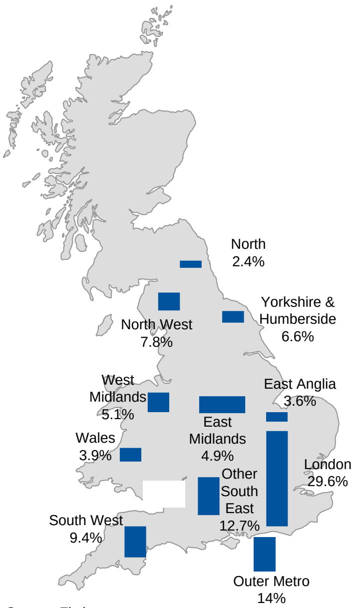
The QSA, calculated using the repossession data provided by Paragon, was 32% for Paragon which is higher than Fitch's criteria assumption of 22% and therefore Fitch increased the QSA adjustment for PM18.

Geographical Concentration

The mortgage portfolio is skewed towards London and the South East (see Figure 2) with 56.3% of the properties in the mortgage portfolio located in London, the South East and Outer Metro.

As the percentage of loans in London, the South East and Outer Metro is higher than the proportion of the UK population in these regions, the portfolio is more exposed to regional economic declines or natural disasters like flooding. Despite London being the largest BTL market in the UK, in order to account for this concentration Fitch increased the default probability of 5% of the loans in the portfolio by 15%.

Geographic Breakdown Location
As of July 2013



Source: Fitch

Default Model Output

The following table illustrates the asset analysis results across different rating scenarios. Fitch has used these WAFF and WARR levels when modelling the transaction cash flows.

Figure 3
Fitch Default Model Output Static

Rating level (%)	WAFF[a]	WARR[b]	MVD[c]
AAA	22.6	47.9	61.4
AA	18.3	53.3	57.4
A	14.1	58.73	53.4
BBB	9.9	64.2	49.4

Recovery time (years): Interest accrued on contractual rate for three years at 'AAA'
Recovery cost: 2.5% plus GBP3,000 fixed cost
[a] Weighted-average foreclosure frequency
[b] Weighted-average recovery rate
[c] Market value decline
Source: Fitch

Financial Structure and Cash Flow Modelling

Credit Enhancement

Subordination

The class B, C and D notes are sized at 5.75%, 5.00% and 2.00% of the mortgage portfolio respectively, and provide credit enhancement to the class A note. Any principal losses resulting from the mortgage portfolio will be recorded on the PDL which will be paid in such a way that the amount corresponding to the Class A notes will be paid first before the amount corresponding to the class B, C and D notes.

Reserve Fund

To provide limited coverage for any interest shortfalls and principal losses, the issuer has established at closing, a non-amortising fully funded reserve fund to the amount of 3% of the initial total collateral balance. This can step up to 4% of the initial total collateral balance if 60+ days arrears exceed 3% of the outstanding note balance or cumulative losses exceed 2%.

The monies held in the reserve fund will not be held in a guaranteed interest contract (GIC) account but will instead be invested in eligible investments, as Paragon believes it will be able to earn a higher rate of return. Fitch has however assumed a sub-Libor rate of return for the purposes of its cash-flow analysis (which is typically the case for a GIC account).

Excess Spread

Excess spread is also a source of credit support and liquidity for all tranches of notes, with the advantage of being a potentially on-going resource. However, unlike "hard" cash collateral, excess spread is dependent on the performance of the pool, and as such is often least available when most needed. It is eroded by delinquencies and defaulted loans, which is compounded if higher margin loans are affected. Should high-margin loans amortise more quickly than those with lower margins (whether as a consequence of divergent prepayment rates or shorter tenures), then there is further compression of excess spread.

To the extent available, excess spread, after meeting other senior expenses and interest on the class A note tranche, will be available to replenish any debit balances that arise on the PDLs. In addition, the excess spread can be used to pay down the class A, B and C notes after three years.

Principal to Pay Interest

If there is a shortfall in revenue funds to pay senior fees and interest on the class A, B and C notes, funds may be reallocated from principal receipts to cover the shortfall. The principal made available to cover these revenue deficits will be recorded on the PDL and is to be recouped from future revenue.

In its cash flow analysis, Fitch has modelled the principal draw mechanism, which is standard among UK RMBS pass-through transactions.

Liquidity Ledger

PM18 benefits from a liquidity ledger within the reserve fund, sized at 3% of the outstanding balance of the class A, B and C notes. This is to be used to cover senior expenses and interest on the class A notes. The liquidity ledger can also be used to cover interest on class B and C notes, subject to the PDL not exceeding 50% of the relevant class balance.

Minimum Mortgage Rate

The administrator must ensure that the WA margin applicable to the mortgages after taking into account all hedging arrangements, income received from the investment of funds in the transaction account, and income from early repayment charges, is not less than three-month sterling Libor plus 4% until September 2018 and three-month sterling Libor plus 4.5% thereafter. Should the WA margin fall below these levels, the mortgage administrator will be obliged to either:

- increase the rates on variable-rate loans in the pool, to ensure sufficient revenue funds are available; or
- make a drawing on the subordinated loan, such that the required levels are met.

Early Amortisation Events: Events of Default

The following will constitute an event of default (EoD):

1. non-payment by the issuer of principal in respect of the notes within seven days following the due date;
2. non-payment by the Issuer of any interest amount on the notes within 15 days following the due date;
3. breach of contractual obligations by the Issuer under the relevant documents which is materially prejudicial to the interests of the holders of the most senior class of notes; or
4. an issuer insolvency event which is materially prejudicial to the interests of the holders of the most senior class of notes.

Hedging

Interest-Rate Risk

Payments received by the issuer under the loans are subject to variable and fixed rates of interest.

Fixed Rate-to-Three Month Pound Sterling Libor (Hedged)

The issuer will enter into an interest-rate swap to address the possible variation between three-month sterling Libor and the rate of interest earned on the fixed loans (38.5%). The swap is a non-balance-guaranteed swap. This hedging is based on a scheduled step-down balance in line with the fixed-rate mortgages' amortisation schedule. There may be mismatches on the swap due to prepayments or defaults on the fixed-rate mortgages. Fitch has taken this into account in its analysis. A small portion of the fixed rate loans (0.4%) will revert to Paragon's SVR.

Libor to SVR (Unhedged)

Libor linked loans (1.6%) in the PM18 pool will remain unhedged and Fitch has has taken this into account in its cash flow analysis. The agency has assumed that the long-term spread of SVR loans to three-month Libor is 350bp. This is to account for the margin compression that tends to occur in SVR loans as underlying interest rise and lenders cannot fully track those increases.

Three-Month Sterling Libor Floating (Unhedged)

Loans linked to three month sterling Libor (60.3%) in this pool will also remain unhedged. Since the notes are also paying Libor, there is less uncertainty in the amount of future excess spread in this deal than in past deals which Fitch has accounted for in its cash flow analysis; Fitch did not apply a haircut in its cash flow analysis in comparison with previous Paragon transactions that had a high percentage of standard variable rate products. The agency did assume a mismatch between the reset dates on the mortgage loans and the notes as part of its cash flow analysis.

Scenario Testing

The capital structure has been stressed in Fitch's rating analysis under certain scenarios, including: high and low CPR scenarios; increasing and decreasing interest-rate scenarios; front and back loaded default curve scenarios.

The stressed scenarios result in no principal losses and the timely payment of interest for each note under each rating category. The most stressful scenarios in the cash flow stress tests are those with an increasing interest rate, high prepayment, back-loaded default curve.

Counterparty Risk

Fitch performed an on-site operational review of Paragon in September 2012 to assess, among other things, the lender's origination, underwriting and servicing capabilities (see *Appendix B*).

Review visits do not constitute 'due diligence' and Fitch does not perform due diligence but relies upon the accuracy of data given to it.

Servicer

Paragon, as the administrator, has delegated its responsibilities to Paragon Finance (PFPLC) which is responsible for administering the mortgage loans in the portfolio.

At the group's West Midlands headquarters, on-going contact with borrowers is maintained via a telephone-based debt management system known as CACS. CACS enables collection agents to schedule calls to borrowers upon a missed payment and provides a detailed, diary-based collections management platform. Fitch notes that this site has substantial operational history, and considers PFPLC to be more than adequate in its role as servicer. Homeloan Management Ltd (HML) has been designated as substitute administrator.

Hedge Providers

Interest Rate Swap

At closing, the issuer will enter into a series of interest rate swaps to eliminate the risk between the fixed rate mortgages and note Libor. This hedging is based on a scheduled step-down balance. The counterparties for the interest-rate swap are Macquarie Bank Limited, rated 'A'/Stable/'F1' and Lloyds TSB Bank plc rated 'A'/Stable/'F1', which satisfy Fitch's expected minimum rating for swap counterparties (detailed in the report entitled *Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum*, published 13 May 2013).

Upon a downgrade of Macquarie Bank Limited or Lloyds TSB Bank plc below Long-Term 'A' or 'F1', one of the following remedial measures must be applied by the swap counterparty:

1. arrangement for a third-party guarantor with the requisite rating;
2. transfer of the swap to a counterparty with the requisite rating;
3. posting of the required collateral to cover the potential loss upon its default; or
4. take such other action as will result in the rating of the notes being maintained or restored.

Only actions (1) and (2) are available upon a downgrade below investment grade. Where collateral is a feasible mitigant — for example, where the swap provider is rated at least investment grade — posting is expected to be effected within 14 calendar days upon the downgrade of the counterparty below 'A' or 'F1'. Where collateral cannot be used as a mitigant, remedial action is expected to be taken within 30 calendar days upon the downgrade of the counterparty.

The swap documents include a clause (remedial measure 4. above) that allows other unspecified actions, in addition to specific remedial actions, upon the breach of certain thresholds. This clause states that there could be alternative remedies that might be pursued so that a rating downgrade would not occur. Fitch does not consider this clause to have any credit quality effect. The agency will always expect compliance with the provisions of its counterparty criteria upon rating threshold triggers being breached. If remedies as specified in the counterparty criteria are not pursued within specified timeframes, Fitch will analyse the impact of this non-compliance in its rating opinion, and a rating action could follow.

Commingling Risk

Collections Account and Account Bank

Mortgage payments are transferred from the servicer's collection account (at Barclays Bank plc, A/ Stable/F1) to the transaction account (National Westminster Bank plc, A/Stable/F1) within one business day. To mitigate any commingling risk, there is a back-up servicer (HML) in place on day one. Additionally, principal and the reserve fund portion, which is not part of the liquidity ledger, may be used to cover for any class A, B and C note interest shortfalls. If that is not adequate, the liquidity ledger sized at 3% of the class A, B and C notes may be used to cover for the class A note interest shortfalls. The liquidity ledger can also be used to cover interest on class B and C notes, subject to the PDL not exceeding 50% of the relevant class balance.

Should the Short-Term IDR of the collection account provider fall below 'F1', or its Long-Term IDR fall below 'A', the collection account must be transferred to an eligible counterparty. This complies with Fitch's criteria on commingling risk (see *Counterparty Criteria for Structured Finance and Covered Bonds*, May 2013, and available at www.fitchratings.com).

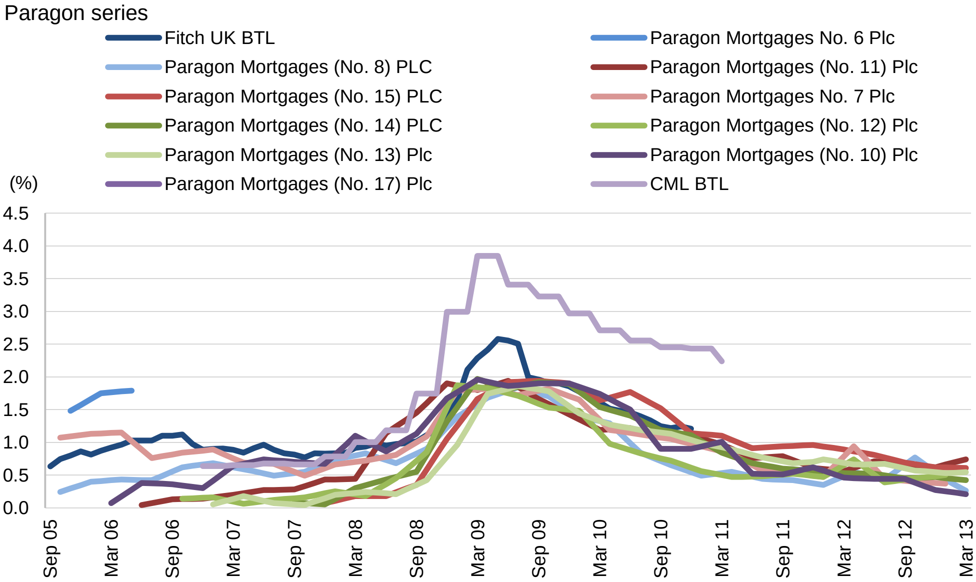
Under the transaction documents, Paragon, as the transaction administrator, is required to undertake the replacement of counterparties including the issuer account bank, qualified investments, collection account bank and derivative counterparty if the counterparties cease to fulfil criteria defined in the transaction documentation. The criteria defined in transaction documentation relate both to specific minimum ratings (eg 'A'/'F1', which are consistent with Fitch's counterparty criteria where the highest rated note is 'AAAsf') and to Fitch's counterparty criteria. This mechanism deviates from Fitch's criteria in that the transaction documents include specific references to Fitch criteria (see *Criteria Updates* in *Counterparty Criteria for Structured Finance and Covered Bonds*) rather than being self-contained.

The reference to Fitch criteria creates a degree of uncertainty regarding future counterparty arrangements but Fitch does not expect this mechanism to negatively affect note ratings so long as the administrator maintains counterparties that are consistent with Fitch's counterparty criteria. Fitch highlights that as a result of the mechanism the replacement of counterparties by the administrator may be affected by a change to the rating of the highest-rated note or a change in the agency's criteria. For example, if the highest rated note was 'Asf' the administrator may be expected to apply a lower minimum rating of 'BBB+'/'F2' to the counterparties. A change in the level of minimum counterparty IDR specified in Fitch criteria may also affect the actions of the administrator.

Performance Analytics

The performance of transactions in the Paragon series remains comparable with one another, with each of the transactions performing well, and better than most other UK BTL transactions. As of March 2013, the percentage of loans in arrears by three months or more ranged between 0.18% (Paragon 8) and 0.72% (Paragon 11) of their respective outstanding collateral balances. Paragon's extensive use of receiver of rent policies has contributed towards the relatively low level of arrears seen across the series.

Figure 4
3m+ Arrears
Paragon series



Source: Fitch, Investor Reports

Related Research

Figure 6

Publication[a]

General rating and structured finance criteria	
Global Structured Finance Rating Criteria	24 May 2013
Counterparty risk criteria	
Counterparty Criteria for Structured Finance and Covered Bonds	13 May 2013
Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum	13 May 2013
Issuer's currency swap obligations rating criteria	
Criteria for Rating Currency Swap Obligations of an SPV in Structured Finance Transactions	8 August 2012
Interest rate criteria	
Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds	25 January 2013
Fitch's Interest Rate Stress Assumptions for Structured Finance	25 January 2013
Mortgage insurance criteria	
Global Criteria for Lenders' Mortgage Insurance in RMBS	7 September 2012
Country-specific criteria	
EMEA Criteria Addendum - United Kingdom - Mortgage Loss and Cash Flow Assumptions	9 August 2012
EMEA Residential Mortgage Loss Criteria	6 June 2013
Country-specific market studies	
UK Residential Property Value Analysis - A Detailed Review of Sold Properties in Possession	28 February 2013
Surveillance	
EMEA Issuer Report Grades – The Results	11 October 2012
Origination and servicing	
Rating Criteria for Structured Finance Servicers	6 February 2013
Criteria for Servicing Continuity Risk in Structured Finance	10 August 2012
NRAC	
No Rating Impact on Holmes Master Issuer PLC From Account Bank Restructure	11 March 2013

All the above research is available at www.fitchratings.com
[a] Criteria can be updated or amended: Readers should always make reference to the latest criteria available at www.fitchratings.com
Source: Fitch

Appendix A

Figure 7

Transaction Comparison

	PM18[c]	PM17	PM16	PM15
Closing date	**TBD**	**October 2012**	**November 2011**	**July 2007**
Total issuance (GBP)	**TBD**	**199,568,741**	**163,800,000**	**1,000,000,000**
Preliminary Credit Enhancement %				
AAA	15. 75	15.5	22.6	16.9
AA	10.00	10.25	n.a.	9.4
A	5.00	5.25	n.a.	1.9
BBB	n.a.	n.a.	n.a.	n.a.
Initial reserve (% of initial balance)	3.0	3.0	3.0	1.9
Target after arrears/loss triggers	4.0	4.0	4.0	2.4
Liquidity	yes	yes	yes	yes
WAFF (%)				
AAA	22.6	20.5	20.8	25.8
AA	18.3	16.6	17.0	20.7
A	14.1	12.8	13.2	15.5
BBB	9.9	9.0	9.4	10.3
WALS (%)				
AAA	69.9	68.3	57.7	44.8
AA	64.5	62.7	51.9	36.1
A	56.6	54.6	44.9	29.6
BBB	51.1	48.9	39.2	21.8
WARR (%)				
AAA	47.9	49.6	50.7	62.8
AA	53.3	55.2	56.4	71.5
A	58.7	60.7	62.2	78.1
BBB	64.2	66.4	67.9	85.8
WAMVD (%)				
AAA	61.4	61.2	59.7	46.6
AA	57.4	57.2	55.5	39.3
A	53.4	53.2	51.3	33.7
BBB	49.4	49.2	47.1	26.9
Portfolio				
Collateral balance (GBP)	224,812,188	199,568,741	128,928,887	677,142,700
Average current balance per borrower (GBP)	172,402	227,041	217,052	146,599
WA original valuation (GBP)[a]	209,205	241,685	236,287	189,563
Largest indexed valuation (GBP)	3,045,000	2,620,862	2,000,000	3,900,000
WA seasoning (months)[a]	3	8	19	1.3
L/OM/SE concentration (%)[a]	56.3	47.4	56.6	50.7
WA OLTV (%)[a]	72.7	69.9	69.8	79.3
WACLTV (%)[a]	72.5	69.6	70.0	79.3
WACLTV (indexed values) (%)[a]	72.5	69.5	70.4	79.1
WAOLTV>80% (%)[a]	0.6	0.5	0.2	59.2
WAOLTV>90% (%)[a]	0.0	-	0.0	2.4
WA ICR (%)[b]	82.8	88.1	94.3	96.0
WA stabilised margin (%)	4.7	4.7	3.9	1.9
Interest-only loans (%)	93.6	93.5	90.4	96.0
Buy-to-let (%)	100.0	100.0	100.0	100.0

[a] As calculated by Fitch
[b] As calculated by Paragon using Fitch's interest rate assumption of 5.5% plus the relevant margin
[c] Based on pool data as of July 2013
[e]

Source: Fitch and pool cuts provided by Paragon

Appendix B: Origination, Underwriting and Servicing

Origination

Paragon Mortgages Limited (PML) is a subsidiary of the Paragon Group, which specialises in the provision of various financial products to consumers. As a mortgage company, PML specialises in the origination of BTL products through intermediaries and since February 2001, the vast majority of originations have been to professional borrowers. Since September 2010, a new originator, Paragon Mortgages (2010) Limited has targeted the professional landlord market. To qualify for the benefits of such a loan a borrower must already possess a portfolio of at least three properties and must present a minimum of two years financial accounts for the underwriters to scrutinise.

Such professional borrowers are typically characterised as individuals who earn a substantial portion of their income from the rental yield on their portfolio; indeed, some may rely entirely on this source of income for their livelihood.

For new originations, the rental income from single, self-contained properties must be a minimum of 125% of the mortgage payment calculated on an interest only basis, at either the product rate, or a reference rate of 5%, whichever is the higher. The rental income for all other property types must be a minimum rental income of 130% of the mortgage payment calculated on an interest only basis, at either the product rate, or the reference rate of 7%, whichever is the higher.

PML has five levels of underwriting based on a hierarchy of mandates. To increase borrowings above these levels it may request additional information, such as a business plan or performance data or conduct an interview with the applicant. Large exposures, ie in excess of GBP2m, to single borrowers are monitored via an annual review of accounts, letting conditions, voids, demand, cash flows, as well as a consideration of the borrower’s strategy for the next 12 months. These controls are designed to ensure PML is kept abreast of the performance of key borrowers’ portfolios, and may mitigate against single obligor concentration within the reference portfolio.

As with other BTL lenders, PML prefers to retain manual discretion in its lending procedures rather than adhere to a pro forma approach. As such, a hierarchy of mandates adhering to guidelines and criteria is in place to ensure that accountability is maintained. At the heart of policy-making is the overarching credit committee - comprising four standing members and other experts, that are called upon as appropriate, - which convenes on a monthly basis and presides over any changes to criteria and special cases.

Professional landlords are believed to be more adept at managing a portfolio of properties, monitoring and acting on economic conditions and market indicators, reducing downtimes between tenancies, and selecting tenant types and target locations than standard borrowers. This assertion is based on the time and energy that professional landlords are able to spend administering their portfolio and researching the market.

Underwriting

PML has its own dedicated underwriting team where the underwriters are usually recruited from within the business, and receive one-on-one on-the-job training. If the underwriters are new to the business, it is expected they will need six months training prior to receiving a lending mandate. Monthly sample checks are completed against all underwriters by line management and further random checks are undertaken immediately after completion of a loan. Other control mechanisms are in place on the systems to ensure mandates and lending thresholds are not over-ridden.

HUNTER has been used as a fraud detection tool since 1995 however a successful switch to SIRA (Syndicated Intelligence for Risk Avoidance) occurred during 2006 and is still in place today. Since its re-entry into the buy to let market in 2010, Paragon has introduced a fraud policy to ensure both fraud prevention controls and compliance with regulatory requirements is in place.

Property Valuation

The Paragon Group has 18 regionally based staff surveyors who complete the majority of valuations; the remainder are completed by "panel" surveyors. It is expected that more unusual properties are surveyed by the staff surveyors. All surveys completed by panel surveyors are audited by a Paragon staff surveyor.

Servicing

Paragon has been appointed to act as the administrators for the loans in the pool. Paragon will subcontract its duties to Paragon Finance PLC (PFPLC). PFPLC invested in sophisticated collections technology following adverse credit experience suffered by the group in the early 1990s. At the group's West Midlands headquarters, ongoing contact with borrowers is maintained via a telephone-based debt management system known as CACS. CACS enables collection agents to schedule calls to borrowers upon a missed payment and provides a detailed, diary-based collections management platform. Fitch notes that this site has substantial operational history, and considers PFPLC to be more than adequate in its role as servicer.

PFPLC is not a Fitch-rated servicer of residential mortgage loans. For more information on Fitch's servicer rating programme see the reports titled *Global Rating Criteria for Structured Finance Servicers*, dated 30 September 2009 and *Rating Criteria for European Residential and Commercial Mortgage Loan Servicers – UK Market Addendum*, dated 28 January 2008.

Early Arrears Management

The servicing team currently manages the Paragon portfolios. Collectors will not see the loan unless it fails a direct debit payment. When that happens for the first time, a telephone call will be made to the borrower within 24 hours to attempt to rectify the situation.

Serious Arrears Management

If the borrower is two months in arrears, Paragon will appoint a Receiver Of Rent (property agent) on the entire portfolio of the borrower. No court approval is required for this. Paragon will send a surveyor with a property agent to the property and inform the tenant that they have to send their rent to the ROR, who forwards it on to Paragon, instead of paying the landlord. No monies from that point onwards are allowed to be passed on to the borrower. Payments received in excess of monthly mortgage payment are used to prepay the loans. A locksmith will also change the locks to the property where the property is not tenanted and a decision will be made to either rent or sell the property.

Even if the borrower becomes current at a later date, Paragon will not usually release the receiver of rent, which effectively forces a borrower to redeem all the mortgages with Paragon.

Foreclosure, Repossession and Sale

Once receiver of rent is appointed, the property cannot be sold if a tenancy is in effect unless it is in the best interests of the debt. At the end of the tenancy, Paragon could theoretically extend the tenancy if it chose to, but usually they would obtain vacant possession and sell the property.

Standby Servicing

Fitch considers the continuous, efficient servicing of the mortgage portfolio as fundamental to the successful performance of a mortgage-backed transaction. As such, it monitors that adequate arrangements are in place to ensure continued servicing in the instance that the named servicer in a transaction is unable to perform its duties. HML is the standby administrator.

Appendix C: Transaction Overview

Paragon Mortgages (No.18) PLC — UK / Prime RMBS

Figure 8
Capital Structure

Class	Expected Rating	Size (%)	Size (GBPm)	CE (%)	Interest rate	PMT freq	Maturity	Margin (%)
A	AAAsf	TBD	TBD	15.75	3-month Libor	Quarterly	Mar 2041	TBD
B	AAsf	TBD	TBD	10.00	3-month Libor	Quarterly	Mar 2041	TBD
C	Asf	TBD	TBD	5.00	3-month Libor	Quarterly	Mar 2041	TBD
D	NR	TBD	TBD	n.a.	3-month Libor	Quarterly	Mar 2041	TBD

Reserve fund	3%
Liquidity ledger	3% of class A, B and C
First interest payment date	15 Dec 2013
Issuer call date	15 Dec 2016

Source: Transaction documents

Key Information

Closing date	[TBD]	**Parties**	
Country of assets	UK	**Seller/originator**	Paragon Mortgages (2010) Limited
Country of SPV	UK	**Servicer**	Paragon Finance plc
Structure	Sequential	**Arrangers**	Macquarie Bank Limited, London Branch and Lloyds TSB Bank plc
Settlement		**Joint lead managers**	Lloyds TSB Bank plc, Macquarie Bank Limited, Morgan Stanley
Listing	London Stock Exchange	**Principal paying agent**	Citibank, N.A., London Branch
Analysts	Tulika Oommen	**Collection account/ Transaction account**	Barclays Bank plc / National Westminster Bank plc
	Shomas Kayani	**Swap counterparties**	Macquarie Bank Limited and Lloyds TSB Bank plc

Source: Transaction documents

Summary

Rating Drivers

- **Prime Portfolio:** This is a prime BTL portfolio with a weighted average (WA) seasoning of 3 months, a WA original LTV (OLTV) of 72.7%, an indexed WA current LTV (CLTV) of 72.5% and a WA interest-coverage-ratio (ICR) of 81.5%. The proportion of loans concentrated in London, Outer Metropolitan and the South East is 56.3%.
- **Paragon Performance:** The portfolio consists entirely of BTL loans and Fitch continues to stress the portfolio's default rates beyond those of a prime owner-occupier portfolio at all rating levels, despite the fact historically the Paragon series has been one of the better performing BTL series. The series continues to perform robustly with low arrears and defaults; 3 month plus arrears are below 75bps for the entire series as of March 2013. This was factored into Fitch's rating analysis.
- **Libor Linked Products:** The transaction has a high percentage of LIBOR-linked loan products (60.3%) and loans that revert to a LIBOR-linked product (38.1%) in comparison with previous Paragon transactions that had a high percentage of standard variable rate loan products. Since the notes are also paying LIBOR, there is less uncertainty regarding the amount of future excess spread in this deal than in past deals, which Fitch has accounted for in its cash flow analysis.
- **Counterparty Rating Trigger Risks:** The rating triggers for the issuer account bank, qualified investments, collection account bank and derivative counterparties in the transaction documents have specific reference to Fitch criteria. This creates a degree of uncertainty regarding future counterparty arrangements (see Counterparty Risk below for further details) but Fitch does not expect this mechanism to negatively affect note ratings so long as the administrator maintains counterparties that are consistent with Fitch's counterparty criteria.

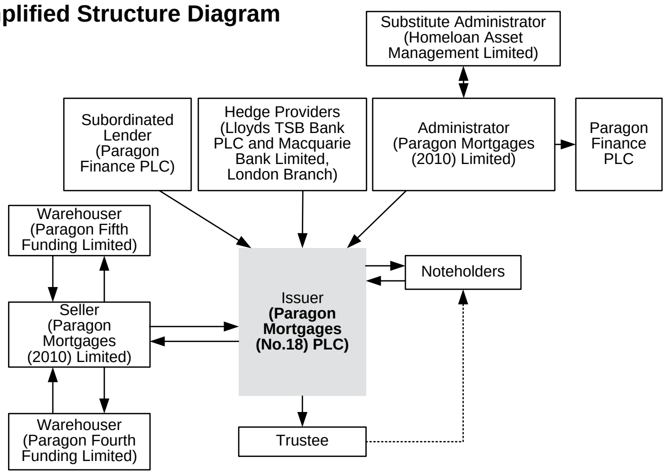
Source: Transaction documents provided by Paragon

Fitch Default Model Output (Static pool)

Rating level	AAA	AA	A	BBB
WAFF (%)	22.6	18.3	14.1	9.9
WARR (%)	47.9	53.3	58.3	64.2
Loss severity (%)	69.9	64.5	56.6	51.1
MVD	61.4	57.4	53.7	49.4

Source: Transaction documents

Simplified Structure Diagram



Source: Transaction documents

Collateral Summary

Final pool characteristics (as of 31 July 2013)

Original principal balance[a]	225,379,228	**Regional concentration (%)**	
Current principal balance [a]	224,812,188	London, SE & OM	56.3
Average current loan per borrower	172,837	South West	9.4
Number of borrowers[a]	1,304	North West	7.9
Number of loans[a]	1,505	Yorks,and Humber	6.6
Seasoning (years)[a,c]	0.3		
Loan to value (LTV) (%)		**Lien position:**	
WA OLTV	72.7	First ranking	100.0
WA CLTV	72.5	Jumbo (%)	20.7
Mortgage characteristics		**Payments**	
WA ICR[a,b]	82.8	Payment frequency	Monthly
Buy to Let (%)	100.0	Payment method	Direct debit
		Performing loans (%)	99.9
Interest rate type			
Floating rate loans (%)	61.9	**Employment status**	
Fixed rate loans (%)	38.1	Self-employed (%)	54.9

Source: Pool Data provided by Paragon

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.