STANDARD & POOR'S RATINGS SERVICES

RatingsDirect®

Presale:

Paragon Mortgages (No.18) PLC

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Related Criteria And Research

Presale:

Paragon Mortgages (No.18) PLC

Sterling-Denominated Mortgage-Backed Floating-Rate Notes

This presale report is based on information as of September 10, 2013. The ratings shown are preliminary. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings.

Class	Prelim. rating*	Prelim. amount (mil. £)	Available credit support§ (%)	Interest	Optional call date	Legal final maturity
A	AAA (sf)	TBD	12.81	Three-month LIBOR plus a margin	December 2016	March 2041
B	AA (sf)	TBD	7.06	Three-month LIBOR plus a margin	December 2016	March 2041
C	A (sf)	TBD	2.06	Three-month LIBOR plus a margin	December 2016	March 2041
D	NR	TBD	0.06	Three-month LIBOR plus a margin	December 2016	March 2041

*The rating on each class of securities is preliminary as of Sept. 10, 2013, and subject to change at any time. We expect to assign final credit ratings on the closing date subject to a satisfactory review of the transaction documents, legal opinion, and audit. Standard & Poor's ratings address timely receipt of interest and ultimate repayment of principal. §This is the initial credit support LIBOR--London interbank offered rate. NR--Not rated. N/A--Not applicable.

Transaction Participants	
Seller and originator	Paragon Mortgages (2010) Ltd.
Warehousers	Paragon Fourth Funding Ltd. and Paragon Fifth Funding Ltd.
Administrator	Paragon Mortgages (2010) Ltd.
Substitute administrator	Homeloan Management Ltd.
Subordinated lender	Paragon Finance PLC
SFM corporate services provider	Structured Finance Management Ltd.
Paragon corporate services provider	Paragon Mortgages (2010) Ltd.
Issue services provider	Paragon Finance PLC
Hedge providers	Macquarie Bank Ltd., London Branch and Lloyds TSB Bank PLC
Collection account bank	Barclays Bank PLC
Transaction account bank	National Westminster Bank PLC
Trustee	Citicorp Trustee Company Ltd.
Principal paying agent	Citibank, N.A., London Branch
Registrar	Citibank, N.A., London Branch
Arrangers	Macquarie Bank Ltd., London Branch and Lloyds TSB Bank PLC
Joint lead managers	Lloyds TSB Bank PLC; Macquarie Bank Ltd., London Branch; and Morgan Stanley & Co. International PLC
Holdings	Paragon Mortgages (No.18) Holdings Ltd.
Share trustee	SFM Corporate Services Ltd.

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Supporting Ratings	
Institution/role	**Ratings**
Barclays Bank PLC as collection account provider.	A/Stable/A-1
National Westminster Bank as transaction account bank provider.	A/Negative/A-1
Macquarie Bank Ltd., London Branch as swap counterparty.	A/Stable/A-1
Lloyds TSB Bank PLC as swap counterparty	A/Negative/A-1

Transaction Key Features*	
Expected closing date	September 2013
Collateral	U.K. buy-to-let mortgage loans
Principal outstanding of the provisional pool (mil. £)	224.8
Country of origination	England and Wales
Concentration (%)	South East and London: 60.56
Property occupancy	Buy-to-let 100%
Weighted-average indexed current LTV ratio (%)†	72.81
Weighted-average original LTV ratio (%)†	72.91
Average loan size balance (£)	149,376
Loan size range (£)	30,825 to 1,932,104
Weighted-average seasoning (months)	3.97
Weighted-average asset life remaining (years)	
Weighted-average current mortgage loan interest rate (%)	3.90
Arrears >= one-month (%)	0.63
Redemption profile	Interest only (less than 10 years): 1.69% Interest only (10 years or more): 91.82% Repayment: 6.38%
Cash reserve (First Loss Fund)(%)§	3 (see explanation in relevant section)
Postcode concentration	2.23% SW1, 2.0% SE1
Mortgage loan priority	First-ranking

*Data is based on a provisional pool as of July 31, 2013 (see "Transaction Summary"). §We expect that the cash reserve will not be amortizing when we assign final ratings. At closing, 0.06% of the cash reserve will be available to cover losses. †LTV calculations are based on Standard & Poor's methodology. LTV--Loan-to value.

Transaction Summary

Standard & Poor's Ratings Services has assigned its preliminary credit ratings to Paragon Mortgages (No.18) PLC's (PM 18) class A, B, and C notes. At closing, PM 18 will also issue unrated class D notes.

At closing, the issuer will use the class A to D notes' proceeds to purchase from Paragon Mortgages (2010) Ltd. (Paragon) £224.8 million of mortgage loans.

Paragon Mortgages (2010) Ltd. originated all loans in the transaction and will act as mortgage administrator. Homeloan Management Ltd. will act as the substitute administrator.

The pool's composition could change further owing to the purchase of further advances during the transaction's life. The addition of further advances are subject to the satisfaction of a number of conditions specified in the transaction

documents. These conditions aim to ensure that the pool's credit quality does not change dramatically as a result of the addition further advances (see "Strengths, Concerns, And Mitigating Factors").

Our ratings reflect our assessment of the transaction's main features, as well as our analysis of the transaction's counterparty and operational risks.

We incorporated in our analysis all of the transaction's structural features and the results indicate that the available credit enhancement for the tranches is sufficient to mitigate the credit and cash flow stresses at the assigned rating levels.

Notable Features

Paragon, a specialized and experienced buy-to-let lender and servicer, originated a number of transactions before 2007 but stopped originating mortgages between 2008 and 2010. PM 18 will be the second transaction from Paragon that we have rated since 2007, and Paragon's third securitization since it resumed lending in 2010.

The collateral pool consists entirely of first-ranking buy-to-let mortgages originated since the beginning of 2011.

98.38% of the loans in the pool are currently in their fixed or discount period. 38.05% pay a fixed rate of interest and the remaining 61.95% pay at a rate linked to LIBOR. A small percentage of loans (1.62%) in the pool are not in a discount period and pay a floating rate of interest linked to LIBOR.

After the end of the fixed or discount period, 98.02% of the loans will revert to a rate linked to LIBOR plus a variable margin, floored at LIBOR +4.50%. The remainder will revert to an administered rate.

The transaction does not have a basis risk swap in place, therefore the portion of the pool comprising loans paying a rate linked to LIBOR, both before and after the reversionary date, will be subject to basis risk, as the LIBOR on the notes resets three months before the interest payment date (IPD; for example, the rate for the June 15 IPD is set on March 15), while the assets reset on the first day of January, April, July, and October. We have considered this risk in our analysis.

Strengths, Concerns, And Mitigating Factors

Strengths

- In our view, Paragon is an experienced buy-to-let mortgage loan originator and servicer.
- Homeloan Management will act as a back-up servicer for the transaction. We consider Homeloan Management to be an above-average mortgage servicer.

Concerns and mitigating factors

- 100% of the loans in the preliminary pool are buy-to-let mortgages. Buy-to-let properties are exposed to different foreclosure risks than owner-occupied properties. These risks include the borrower's level of reliance on the rental receipts to meet mortgage payments and the borrower's prior experience in managing rental properties. We have considered these features in our analysis.
- Credit support is provided by the first loss liquidity excess amount (FLLEA) of the first loss fund (FLF). The required

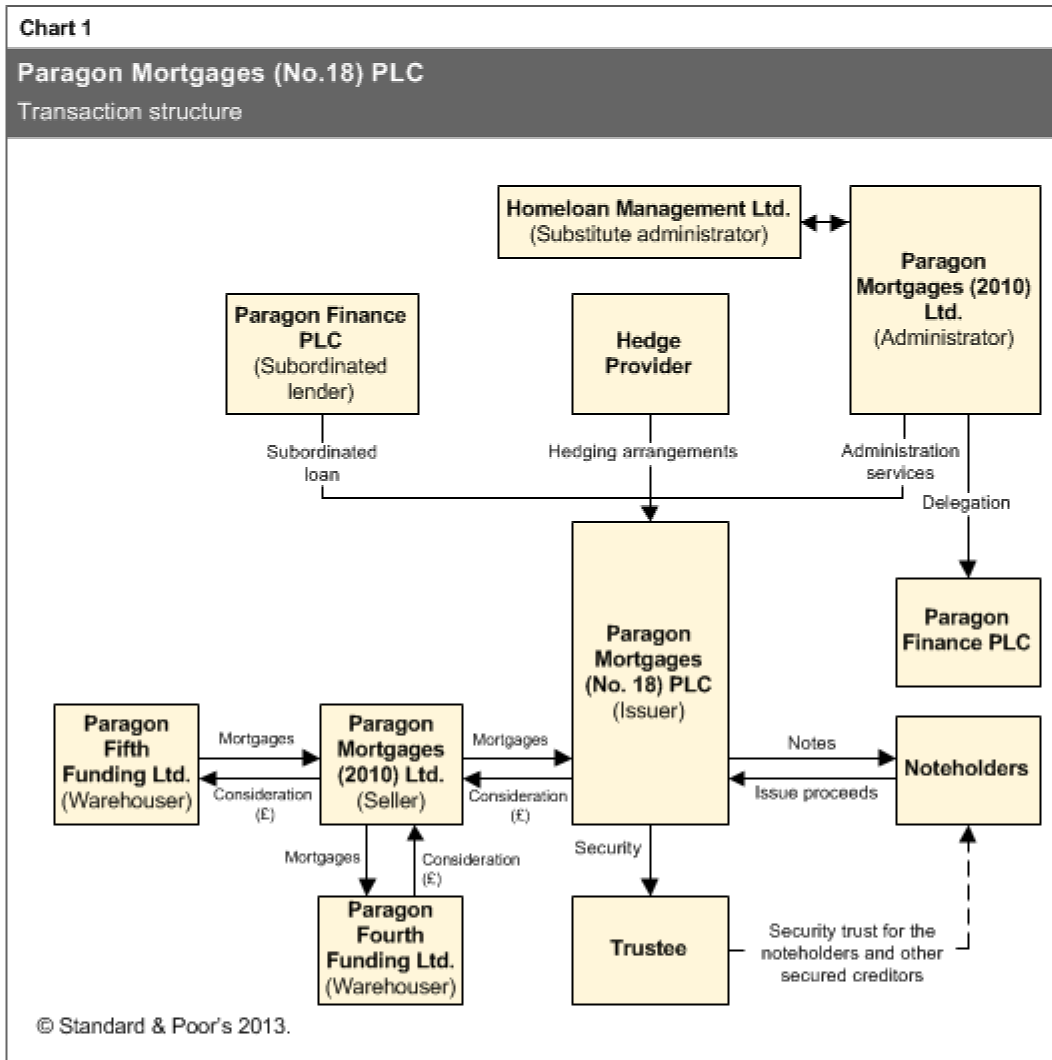
balance of the FLF will not amortize for the life of the transaction. At closing, the FLLEA will amount to 0.06% of the closing note balance (£180,000). The FLLEA is the amount after the liquidity amount (3% of the balance of the A, B, and C notes) is deducted from the FLF. As the A, B, and C notes amortize, this liquidity amount reduces, increasing the required balance of the FLLEA.

- The required balance of the FLF can increase to 4% of the closing note balance if 60+ day delinquencies are greater than 3% or cumulative losses exceed 2% of the outstanding note balance, subject to available excess spread. Subordination and excess spread will provide most of the credit support for the notes.
- Some of the loans in the pool will pay a rate of interest linked to three-month LIBOR, either during the discount period, after the switch to the final rate, or during both periods. The LIBOR rate used to determine the mortgage rate for these loans may be lower than the LIBOR rate used to calculate the interest rate on the notes. This basis risk is not hedged in this transaction. We have incorporated this risk in our analysis.
- 19.68% of the loans in the preliminary portfolio are larger than in a typical U.K. RMBS transaction; large loans are secured against properties with larger-than-average valuations. We stressed jumbo valuations in our loss severity analysis because we consider jumbo properties to be less liquid, attracting higher repossession market value declines (RMVDs).
- The pool shows a very low level of seasoning because all of the loans were originated since the beginning of 2011. We associate seasoned loans with a lower likelihood of foreclosure relative to those that are not well seasoned (but that are otherwise the same).

Transaction Structure

At closing, PM 18 will acquire the beneficial interest in the mortgage loan pool from the seller, Paragon. PM 18 will issue the class A, B, C, and D notes to fund the purchase of the portfolio. PM 18, in contrast with Paragon Mortgages (No.17) PLC (PM 17), is an "orphan" special-purpose entity (SPE). In addition, PM 18 is not a member of the Paragon VAT group, unlike PM 17.

The issuer will grant security over all of its assets in favor of the security trustee (see chart 1).



Seller and portfolio administrators

The Paragon Group Of Companies, through its subsidiary, Paragon, will act as the seller and the mortgage administrator for this transaction. The seller will also hold legal title to the relevant mortgage loans until a perfection of title event occurs.

As part of our standard corporate overview, we conducted a review of Paragon Group's origination, underwriting, and valuation processes, as well as its default-management procedures in September 2012. We are satisfied that Paragon and Homeloan Management are capable of performing their functions in the transaction.

Notes Terms And Conditions

We understand that PM 18 will issue a number of tranches of notes.

Interest on the notes will be payable quarterly in arrears on the 15th of March, June, September, and December each

year, with the first IPD on Dec. 15, 2013.

Optional redemption of the notes

The issuer may redeem all the notes at their principal amount outstanding, together with any accrued interest on or after the interest payment date in December 2016. There will be no step-up margin in this transaction, although from December 2016 excess spread will be used to pay down the outstanding notes.

Mandatory redemption of the notes

The issuer will apply available principal receipts to redeem the notes at each IPD, subject to the principal priority of payments.

Clean-up call

The issuer may redeem all the notes at their principal amount outstanding together with any accrued interest, if the total outstanding balance of the notes is less than 10% of the original balance of all notes at closing.

Amortization of the notes

We expect PM 18 to pay principal receipts sequentially to the noteholders, with the class A notes being redeemed prior to subordinated classes.

Collateral Description

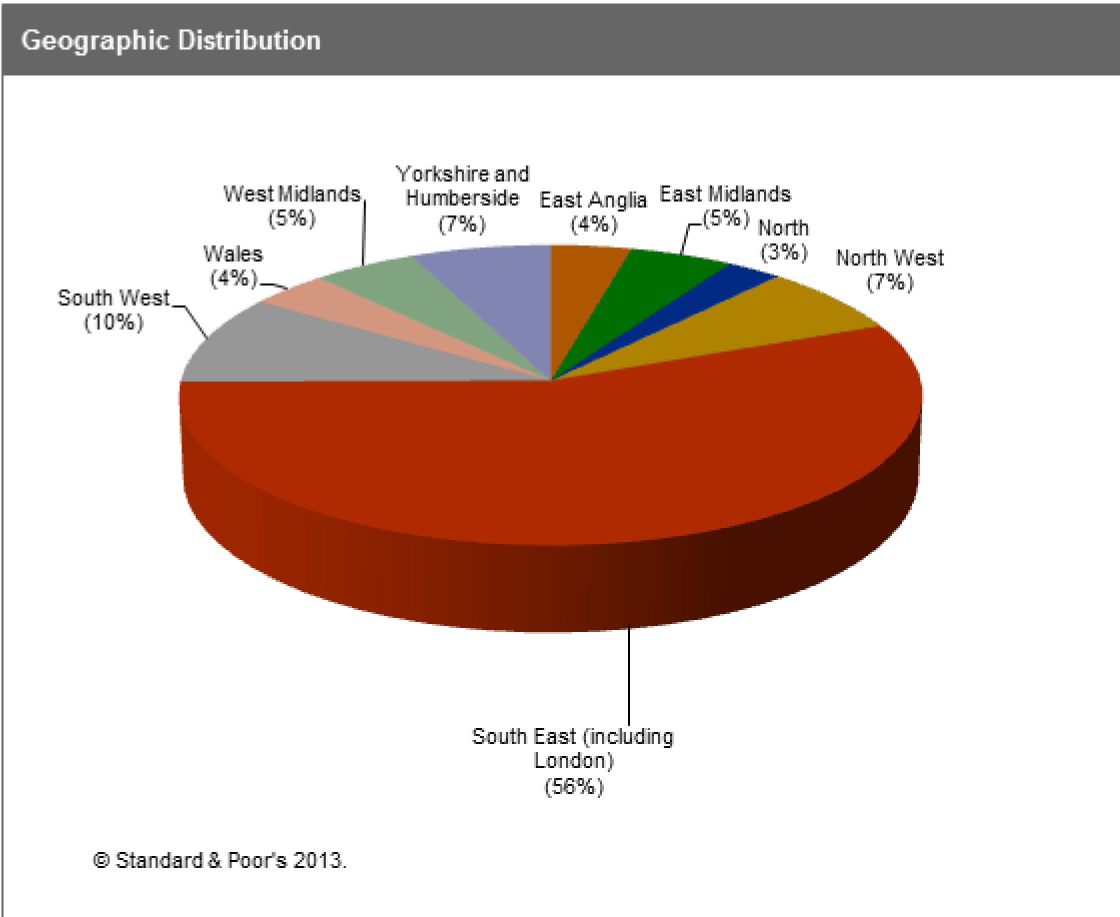
The preliminary mortgage loan pool of £224,812,187.52 comprises 1,505 loans secured against buy-to-let properties. All of the loans were originated in 2011 or later. We associate seasoned loans with a lower likelihood of foreclosure relative to those that are not well seasoned (but that are otherwise the same). We view a mortgage's initial five years as being the most stressful period for a borrower.

The portfolio has a weighted-average indexed current loan-to-value (LTV) ratio of 72.81% and the rental income from the property securing the buy-to-let loans has been verified. The loans in the pool currently show arrears of 0.06% greater than or equal to 30 days.

A feature of the portfolio is the high variety of buy-to-let mortgages. These include professional landlords and lets by individuals through personal or corporate loans (usually through SPEs that are guaranteed by directors). We consider the originator's underwriting levels to be conservative, but the nature of the buy-to-let market creates additional risks compared with a typical prime owner-occupied mortgage portfolio (such as reliance on tenants to make timely rental payments), notwithstanding the weighted-average LTV ratio of this portfolio. These risks are mitigated by Paragon's good understanding of the market as a specialist lender, its conservative buy-to-let underwriting policy, and its dominant position in the professional landlord sector.

The preliminary pool is 56.12% concentrated in South East England and London (see chart 2). We consider this concentration to be excessive, and we have therefore made adjustments for this in our analysis.

Chart 2



The weighted-average original LTV ratio of the collateral in the preliminary pool is 72.91% (see chart 4). We consider that borrowers with minimal initial equity in their property are less likely to be able to refinance, and are more likely to default on their obligations than borrowers with lower original LTV ratio loans. At the same time, loans with high current indexed LTV ratios are likely to incur greater loss severities if the borrower defaults. In the preliminary pool, 99.13% of the loans exhibit a current indexed LTV ratio of lower than 80%, and 19.94% have a current indexed LTV ratio of lower than 70%.

Chart 3

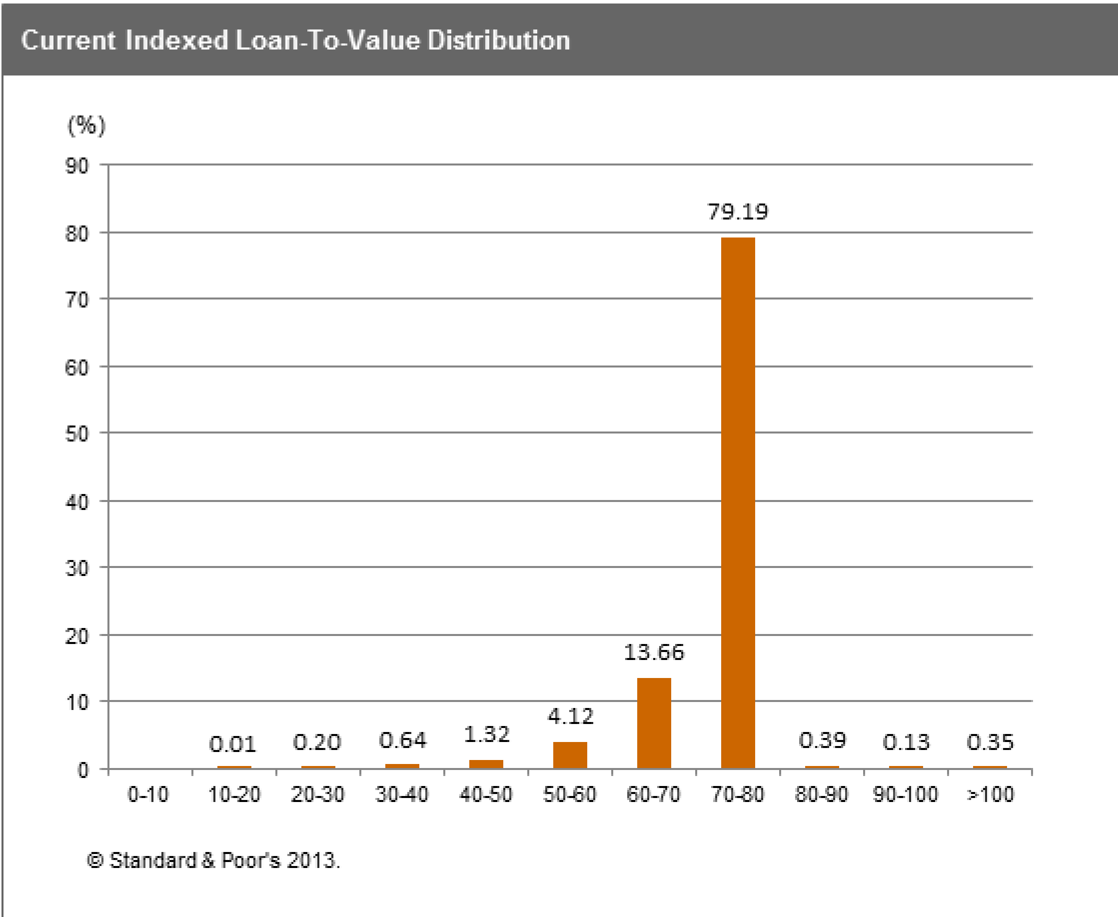
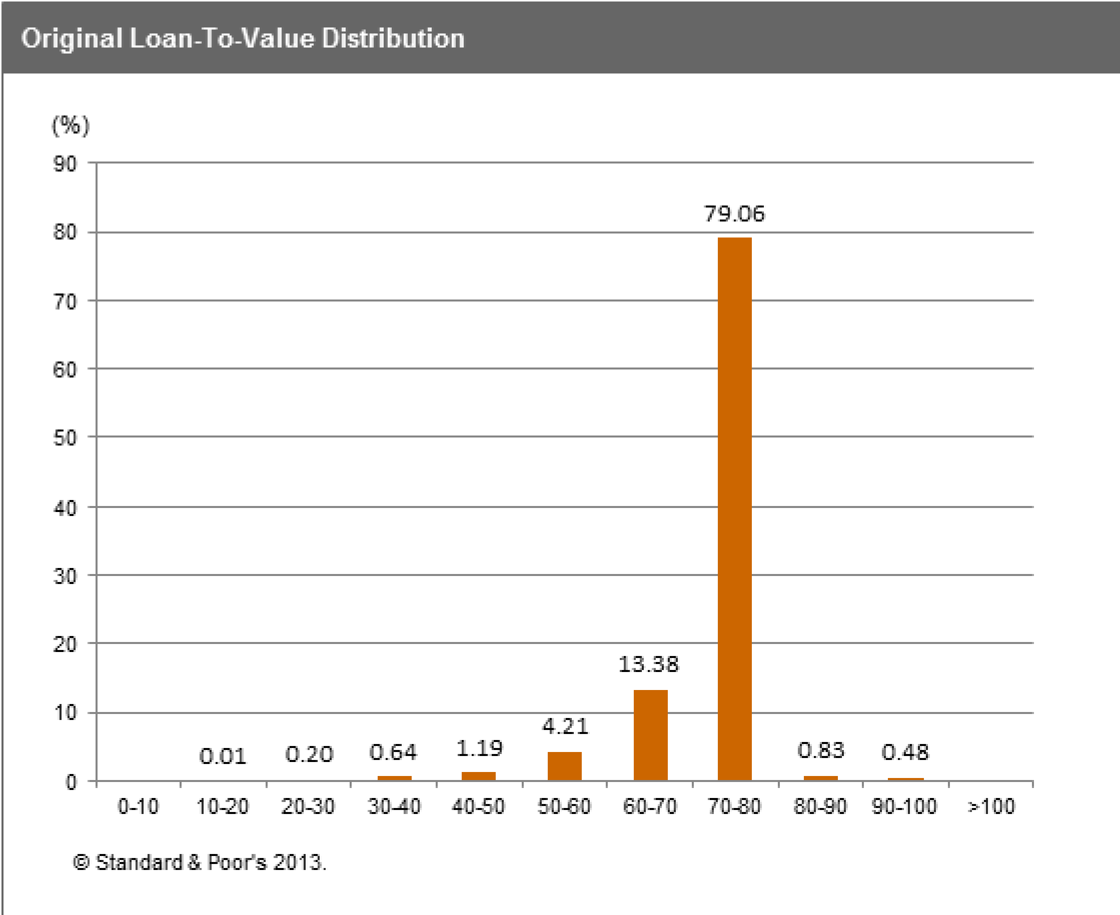
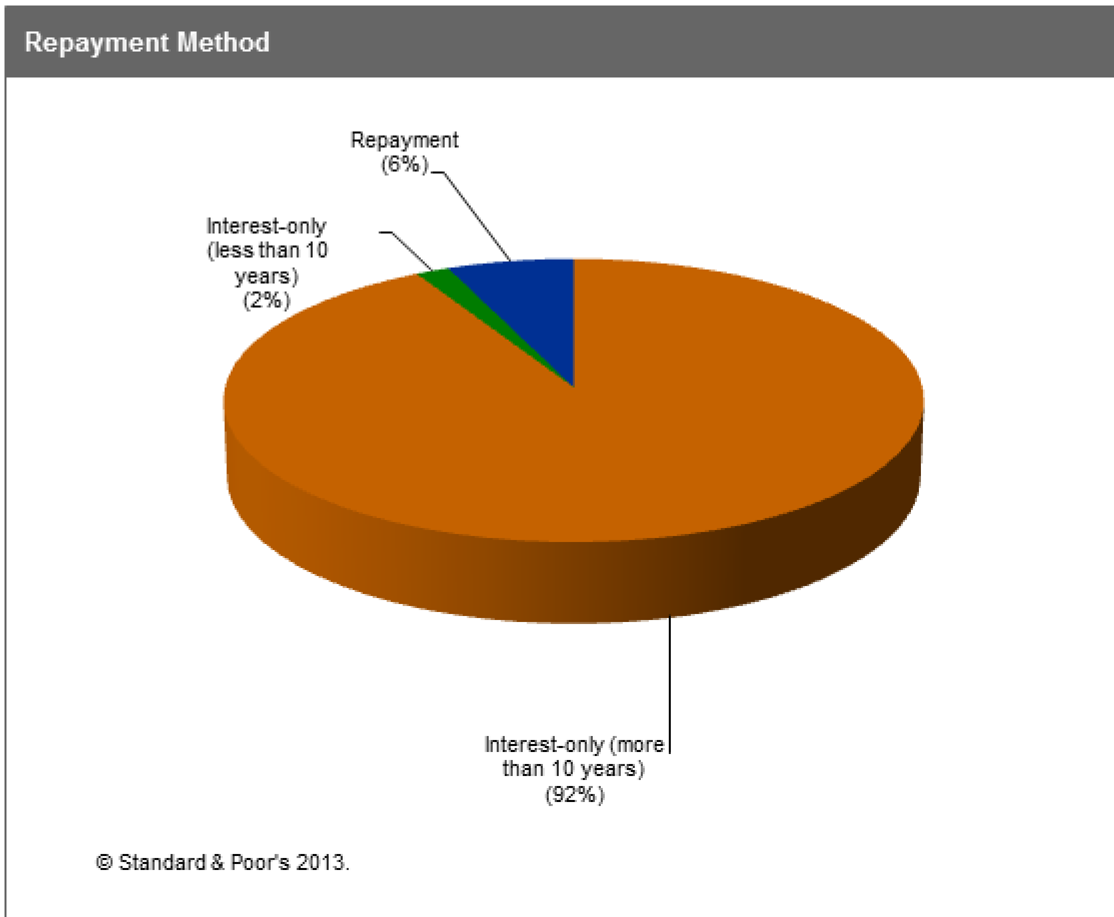


Chart 4



Of the portfolio, 93.62% consists of interest-only (IO) loans. 1.69% of these IO loans have a term of less than 10 years, which we view as higher risk than repayment (REP) or longer-dated IO mortgages. The preliminary pool is 91.82% IO mortgages with a term of 10 years or more, and 0.24% of the pool consists of IO loans that revert to REP within five years. We consider IO loans above 50% of the pool (see chart 5) to be a concentration risk, and we have therefore applied an adjustment of 1.5x, as per our criteria.

Chart 5



Substitutions

If the servicer identifies a loan as being in breach of the representations and warranties of the seller, the seller will be required to repurchase the loan.

Credit Structure

A combination of subordination, the reserve fund, and excess spread on the mortgage loans will provide credit support for the notes (see table 1).

Table 1

Credit Support For The Notes

Class	Prelim. rating	Size of class (%)	Mil. £ (equivalent)	Initial credit support (%)
A	AAA (sf)	87.25	TBD	12.81
B	AA (sf)	5.75	TBD	7.06
C	A (sf)	5.0	TBD	2.06
D	NR	2.00	TBD	0.06

NR--Not rated.

PM 18 will open an account with National Westminster Bank (NatWest), the transaction account. Payments by borrowers are received into collection accounts in the names of the sellers, which are held with Barclays Bank.

Any accounts will be subject to the terms of the transaction documents. The administrator will replace NatWest in its role as transaction account bank with a suitably rated institution in 30 days, if at any time, we lower our long-term issuer credit rating (ICR) on the account bank (in this case, NatWest) below 'A', where the short-term rating is at least 'A-1'.

Similarly, the administrator will replace Barclays in its role as collection accounts bank with a suitably rated institution in 30 days, if at any time, we lower our long-term issuer credit rating (ICR) on the collection accounts bank (in this case, Barclays) below 'A', where the short-term rating is at least 'A-1'.

Under the transaction documents, the borrowers will make their monthly payments in the seller collection accounts held with Barclays. The transaction documents will establish a declaration of trust over any amounts standing to the seller collection accounts. Amounts standing to the credit of the collection accounts will be swept on a daily basis into the transaction account.

First loss fund

The first loss fund (FLF) will be non-amortizing and funded at closing to 3% of the initial notes balance. In the FLF ledger, an amortizing amount equal to 3% of the rated notes outstanding will represent the liquidity amount and only the difference between the FLF and the liquidity amount will form the first loss liquidity excess amount (FLLEA). This will be available to cure credit losses, whereas the liquidity amount will provide only liquidity support to the rated notes and senior expenses.

The amount available to cure losses, at inception, through the FLLEA is just six bps, but, when the notes start to amortize, we expect the FLLEA to increase in size, following the amortization of the liquidity amount, with more credit enhancement being available to the tranches.

The required amount of the FLF will increase to 4% of the initial note balance if:

- 60+ day arrears are more than 3% of the current balance of the mortgages in the portfolio; or
- Cumulative losses are equal or greater than 2% of the original balance of the notes.

The issuer will replenish the reserve FLF from excess spread, if available, and principal receipts.

Minimum mortgage rate mechanism

The loans in the pool are currently either fixed- or floating-rate at LIBOR plus a margin. After the end of the fixed or tracker period, eight loans revert to the administered rate, and the remainder revert to three-month LIBOR.

For the loans paying the administered rate, the administrator will be able to vary the interest rate on a loan-by-loan basis. However, in line with the administration agreement, the administrator in question may set the interest rate at a level that is sufficient to ensure that the average yield on the entire pool plus any other income that the issuer receives from any hedging agreements or any releases from MRF will be no lower than the minimum mortgage rate (MMR). The MMR is set at three-month LIBOR plus 4.0% for the first five years and thereafter, three-month LIBOR plus 4.5%.

The three-month LIBOR used in the calculation of MMR is the three-month LIBOR used to determine the coupon on the bonds for each quarterly period.

If the administrator decides to set the rates on the mortgages below a level that fails to maintain the MMR, it may post an amount equal reflecting the difference into the shortfall fund.

If Paragon is replaced as administrator, the obligation to set the rates on the pool in order to guarantee the MMR will pass onto the trustee and then to the substitute administrator.

Since the rate for the loans can be adjusted only once the loans have reverted to the administered rate, the administrator's ability to maintain the MMR may be limited during the period when a large portion of the loans are still in their fixed or tracker period, in our view. We have taken this limitation into account in our cash flow analysis. Given the percentage of loans in the pool which will revert to the administered rate (1.98%), we do not see this limitation as being as significant in this transaction as in PM 17, which had more loans reverting to the administered rate.

Principal to pay interest

PM 18 can use principal to pay interest if other revenue sources are insufficient for this purpose. If this occurs, the balance would be recorded to the principal deficiency ledger (PDL) and may reduce the available credit enhancement for the notes. However, the issuer can only use principal to pay interest on all classes of notes, except for the class A notes (on which there are no restrictions on the use of principal to pay interest), if the relevant class' PDL does not exceed 50% of the tranche's size and 100% of all classes of notes ranking junior to it.

Priority of payments

The revenue priority of payments will be as follows:

- Senior fees;
- Swap payment;
- Class A interest;
- Class A PDL;
- Class B interest;
- Class B PDL;
- Class C interest;
- Class C PDL;
- Issuer profit amount;
- Class D PDL;
- FLF top-up; and
- Subordinated payments (including the class D notes' interest, sub loan interest, swap defaulted termination payments, and deferred purchase consideration).

The principal priority of payments will be as follows:

- Top up liquidity amount (part of the FLF) if required;
- Further advances;
- Class A principal;
- Class B principal;

- Class C principal;
- Class D principal; and
- Subordinated loan principal.

After the call option in December 2016, PM 18 will use excess revenue after the topping up of the FLF to pay down the rated notes.

Principal deficiency ledger

The PDL will comprise four sub-ledgers: The class A notes' PDL, the class B notes' PDL, the class C notes' PDL, and the class D notes' PDL. Losses (or use of principal receipts and LA) will first be allocated to the PDL in reverse order of seniority with the class D PDL being debited first.

Further advances

The transaction allows for both mandatory and discretionary further advances to be granted. The structure allows the issuer to purchase discretionary further advances of up to 8% of the notes' original balance, if it has sufficient funds to do so.

Hedging Risk

Fixed-to-floating swap

The issuer will enter into a fixed-to-floating swap with Macquarie Bank Ltd. and/or Lloyds TSB. Under the swaps, the issuer will pay a fixed rate of interest in exchange for the three-month LIBOR that is used to determine the coupon on the notes.

The notional of the swap at closing will roughly correspond to the balance of fixed-rate loans in the pool.

The notional of the swap will amortize following a predefined schedule regardless of the prepayments or defaults on the fixed-rate loans.

Credit And Cash Flow Analysis

We stress the transaction's cash flows to test the credit and liquidity support that the assets, subordinated tranches, and cash reserve provide.

We apply these stresses to the cash flows at all relevant rating levels. For example, this transaction incorporates tranches that we rate 'AAA' and tranches that are not rated. We therefore apply one set of cash flow stresses. In our stresses on the 'AAA' rated notes, all notes must pay full and timely principal and interest. However, this is not necessarily the case for the tranches of unrated notes because they are subordinated in the priority of payments.

Credit enhancement

The 'B' credit enhancement level for the standard U.K. mortgage loan pool is commensurate with our current assumptions of expected losses on that pool (see "U.K. RMBS Methodology And Assumptions," published on Dec. 9, 2011). These expected losses vary according to changes in the outlook for the U.K. mortgage market and cover

macroeconomic factors such as unemployment, inflation, and current mortgage performance, among other factors. The current 'B' level of credit enhancement includes a foreclosure frequency component for the standard U.K. mortgage loan pool, as shown in table 2. We used the assumptions in table 5 as part of our credit analysis of the underlying assets in this transaction.

Table 2

Assumptions

Rating level	Base foreclosure frequency component for an archetypical U.K. mortgage loan pool (%)
AAA	12.0
AA	8.0
A	6.0
BBB	4.0
BB	2.0
B	1.5

Amount of defaults and recoveries

We model the foreclosure frequency for each loan in the pool, as well as the amount of loss upon the subsequent sale of the property (the loss severity, expressed as a percentage of the outstanding loan). We model a default of the total mortgage loan balance. We determine the total amount of the unrecovered defaulted balance for the entire pool by calculating the weighted-average foreclosure frequency (WAFF) and the weighted-average loan severity (WALS). When comparing the minimum credit enhancement levels that we consider commensurate with each rating level with that of this pool, we also included interest foregone between the point of default and the receipt of recoveries (see table 3).

Table 3

Assumptions

Rating level	Minimum credit enhancement level (%)	Initial credit enhancement modeled for this pool (%)
AAA	4.0	15.99
AA	2.5	10.24
A	1.5	6.42

The WAFF and the WALS increase in tandem with the rating level because notes with a higher rating should be able to withstand a higher level of mortgage default and loss severity. Our credit analysis is based on the characteristics of the loans and the associated borrowers, as well as our subsequent assessment of the WAFF and the WALS for this portfolio, which were the inputs that we used in our cash flow analysis (see table 4).

Table 4

Portfolio WAFF, WALS, And Credit Enhancement

Rating level	WAFF (%)	WALS (%)	Credit enhancement (%)
AAA	29.90	38.59	11.54
AA	21.27	33.30	7.08
A	16.88	23.37	3.95

WAFF--Weighted-average foreclosure frequency. WALS--Weighted-average loan severity.

For modeling purposes, the repossession market value declines that we apply under our criteria to calculate the loss severity incorporate our calculation of the degree of over- or under-valuation for each U.K. region (see "U.K. RMBS Methodology And Assumptions," published on Dec. 9, 2011). Table 5 shows the resulting market value declines that we used in our analysis of this pool.

Table 5

Repossession Market Value Declines At 'AAA', 'AA', And 'A' Rating Levels

Region	AAA (%)	AA (%)	A (%)
East Anglia	49.42	45.94	39.04
East Midlands	47.70	44.49	37.84
North	46.58	43.54	37.05
North West	47.06	43.95	37.39
Northern Ireland	42.82	39.89	33.53
Scotland	44.59	41.65	35.26
South East (including London)	52.87	48.88	41.48
South West	54.92	50.63	42.92
Wales	49.58	46.08	39.16
West Midlands	48.70	45.34	38.54
Yorkshire and Humberside	44.68	41.73	35.35

Default timings

At each rating level, the WAFF specifies the total balance of the mortgage loans that we assume to default over the transaction's life. We model these defaults to occur over a three-year recession. Further, we test the effect of the timing of this recession on the ability to repay the liabilities by starting the recessionary period at closing and the start of year 3.

We apply the WAFF to the principal balance outstanding at the closing date. We model defaults to occur periodically, in amounts calculated as a percentage of the WAFF. The timing of defaults follows two paths, referred to as "front-loaded" and "back-loaded" (see table 6).

Table 6

Default Timings For Front-Loaded And Back-Loaded Default Curves

Recession month	Front-loaded defaults (percentage of WAFF per month)	Back-loaded defaults (percentage of WAFF per month)
1–6	5.0	0.8
7–12	5.0	0.8
13–18	3.3	1.7
19–24	1.7	3.3
25–30	0.8	5.0
31–36	0.8	5.0

WAFF--Weighted-average foreclosure frequency.

Timing of recoveries

We assume that the issuer regains any recoveries 12 months after a payment default for buy-to-let properties. The value of recoveries at each rating level is 100%, minus the WALS for that rating level.

The WALS that we use in the cash flow model is based on principal loss, including foreclosure costs. We do not give credit for the recovery of any interest accrued on the mortgage loans during the foreclosure period. After we apply the WAFF to the balance of the mortgage loans, we find that the asset balance is likely to be lower than that of the liabilities. Our test shows that the interest reduction caused by the defaulted mortgage loans during the foreclosure period is covered by the transaction's other structural mechanisms.

Delinquencies

We model the liquidity stress that results from short-term delinquencies (those mortgage loans that cease to pay for a period of time, but then recover and become current with respect to both interest and principal). To simulate the effect of delinquencies, we model a proportion of scheduled collections equal to one-third of the WAFF to be delayed. We apply this in each of the first 18 months of the recession, and model full recovery of these delinquencies to occur 36 months after they arise. Therefore, if the total scheduled collateral collections expected to be received is £1 million and the WAFF is 30% in month five of the recession, £100,000 (one-third of the WAFF) is delayed until month 41.

Interest and prepayment rates

We model five different interest rate scenarios: up, down, up-down, down-up, and forward curve. We model three prepayment scenarios at all rating levels—high, low, and forecast. During the recessionary period, we model the prepayment rate at 3%, before gradually reverting to a high prepayment rate under both scenarios. At the 'AA' level and above, we model an additional low prepayment scenario, which also reverts to a low prepayment rate after the recession period. For this transaction, we modeled the forecast constant payment rate as 0.5%. This figure is based on the average constant prepayment rate we observed in earlier Paragon transactions over the past year. Given this, we have also considered the scenario in which the prepayment rate both during and after the recession is 0.5%.

In combination, the default timings, recession timings, interest rates, and prepayment rates described above give rise to 60 different scenarios at a 'AAA' rating level (see table 7). The ratings we assign mean that the notes have all paid timely interest and ultimate principal under each of the scenarios at the assigned rating level.

Table 7

RMBS Stress Scenarios

Rating level	Total number of scenarios	Prepayment rate	Recession start	Interest rate	Default timing
AAA	60	High, expected, and low	Closing and year 3.	Up, down, up-down, down-up, forward for standard run.	Front-loaded and back-loaded
AA- and below	40	High and low	Closing and year 3.	Up, down, up-down, down-up, forward for standard run	Front-loaded and back-loaded

Given the transaction's structure, the more stressful scenario for our cash flow analysis is a high collateral prepayment rate in an increasing interest rate environment.

Scenario Analysis

Various factors could lead us to lower our ratings on the notes, such as increasing foreclosure rates in the underlying pool, and changes in the pool composition. We have analyzed the effect of increased delinquencies by testing the sensitivity of the ratings to two different levels of movements.

Increasing levels of delinquencies will likely cause more stress to a transaction, and would likely be a contributing factor in the downgrade of rated notes.

In our analysis, our assumptions for the increase in delinquencies are specific to a transaction, although these levels may be similar (or the same) across different transactions. The levels do not reflect any views as to whether these deteriorations will materialize in the future; however, our analysis already incorporates additional adjustments to the default probability of the pool by projecting buckets of expected arrears.

Note that even under these scenarios, structural features in securitizations may mitigate these deteriorations in performance.

Further delinquencies of 8%

In the first scenario, in addition to the rating-dependent stress assumptions, we apply a further 8% increase in nonperforming loans. These are split equally between the one-month and three-month buckets. In the second scenario, we apply an increase of 8%, but all the loans are deemed to have missed three monthly payments. The default probability we assign to a loan increases in tandem with the monthly payments missed. As a consequence, assuming that all loans have missed three monthly payments, the increase in the WAFF would be greater in the second scenario.

Table 8

Assuming An Additional 8% Of Arrears, Split Equally Between One Monthly Payment And Three Monthly Payments Missed

Rating on the notes	WAFF (%)	WALS (%)
AAA	34.97	38.59
AA	25.42	33.3
A	19.84	23.37

WAFF--Weighted-average foreclosure frequency. WALS--Weighted-average loan severity.

Table 9

Assuming An Additional 8% Of Arrears, All Of Which Have Missed Three Monthly Payments

Rating on the notes	WAFF (%)	WALS (%)
AAA	37.97	38.59
AA	27.42	34.34
A	21.04	23.37

WAFF--Weighted-average foreclosure frequency. WALS--Weighted-average loan severity.

Under the first scenario, the ratings on the notes in the transaction would not suffer a ratings transition of more than one level (for example, the 'AAA' rated notes would achieve a rating of at least 'AA').

Under the second scenario, the ratings on the notes would not suffer a rating transition of more than two levels (for example, the 'AAA' rated notes would achieve a rating of at least 'BBB').

Under scenario one, the class A notes pass at a 'AA+' rating level, the class B notes pass at a 'AA-' rating level, and the class C notes pass at a 'A-' rating level.

Under scenario two, the class A notes pass at a 'AA+' rating level, the class B notes pass at a 'A+' rating level, and the

class C notes pass at a 'BBB+' rating level.

It should be noted that we based the analysis above on a simplified assumption, i.e., that the increase in arrears materializes immediately on the day after closing. In reality, these are likely to occur over a period of time. Therefore, other factors, such as seasoning or repayments of some loans, could partially mitigate the effect of deteriorating performance of other loans.

Sectoral Credit Highlights

In the first quarter of 2013, the U.K.'s GDP increased by 0.3% quarter-on-quarter, while the unemployment rate increased marginally by 0.1% to 7.9%. Our latest economic research forecasts 0.6% real GDP growth for the U.K. in 2013, and 1.4% in 2014 (see "Economic Research: Recession Keeps House Prices in the Dumps in Most European Market," published on May 7, 2013).

According to the OECD, house prices in 2012 increased by 2.3%. However, despite improving prospects for the U.K. housing market, mainly because of government mortgage relief measures and low interest rates, price-to-income ratios still suggest homes are overvalued. In our view, therefore, we expect a fairly moderate 1.5% increase this year and 1% in 2014.

Despite our forecast that the housing market will stay broadly stable, prime mortgage borrowers remain under financial pressure because of the worsening economy. Although the level of arrears in the underlying collateral backing U.K. prime RMBS transactions (which resemble buy-to-let transactions in terms of performance) remained stable in the fourth quarter of 2012, the proportion of borrowers in arrears for more than 90 days increased by 0.18% year-on-year. Some of this increase can be attributed to loans being repurchased from better-performing master trusts. The prepayment rate for prime transactions also declined to 13.80% from 16.20% in the third quarter of 2012. Payment rates are falling for prime and nonconforming transactions (see "U.K. RMBS Index Report Q4 2012: Nonconforming Mortgage Arrears Fall To Their Lowest Level Since 2008," published on March 12, 2013).

We expect collateral performance to remain stable overall in the second half of 2013, but the downside risks in the wider economy could affect performance.

Surveillance

We will maintain surveillance on the transaction until the notes mature or are otherwise retired. To do this, we will analyze regular servicer reports detailing the performance of the underlying collateral, monitor supporting ratings, and make regular contact with the servicer to ensure that it maintains minimum servicing standards and that any material changes in the servicer's operations are communicated and assessed.

The key performance indicators in the surveillance of this transaction are:

- Increases in credit enhancement for the notes;
- Total and 90-day delinquencies;
- Cumulative realized losses;

- LTV ratios;
- Constant prepayment rates; and
- Increases in the seasoning of the collateral pool.

Standard & Poor's 17g-7 Disclosure Report

SEC Rule 17g-7 requires an NRSRO, for any report accompanying a credit rating relating to an asset-backed security as defined in the Rule, to include a description of the representations, warranties and enforcement mechanisms available to investors and a description of how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities.

The Standard & Poor's 17g-7 Disclosure Report included in this credit rating report is available at: http://standardandpoorsdisclosure-17g7.com/1794.pdf.

Related Criteria And Research

Related Criteria

- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- U.K. RMBS Methodology And Assumptions, Dec. 9, 2011
- Methodology: Credit Stability Criteria, May 3, 2010
- European Legal Criteria For Structured Finance Transactions, Aug. 28, 2008
- Treatment Of Flexible Mortgage Loans In U.K. RMBS Transactions, April 6, 2005, April 6, 2005

Related Research

- Europe's Recession Is Still Dragging Down House Prices In Most Markets, Jan. 17, 2013
- European Structured Finance Scenario And Sensitivity Analysis: The Effects Of The Top Five Macroeconomic Factors, March 14, 2012
- Global Structured Finance Scenario And Sensitivity Analysis: The Effects Of The Top Five Macroeconomic Factors, Nov. 4, 2011
- U.K. Nonconforming RMBS Index Report, published quarterly
- U.K. Prime RMBS Index Report, published quarterly

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