Paragon Mortgages No. 3 PLC, Multi Class Mortgage Backed FRNs

UK — MBS

EXPECTED CLOSING DATE:
[•] 2001

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This pre-sale report addresses the structure and characteristics of the proposed transaction based on the information provided to Moody's as of 17th April 2001.

Investors should be aware that certain issues concerning this transaction have yet to be finalised. *Upon conclusive review of all documents and legal information as well as any subsequent changes in information, Moody's will endeavour to assign* ***definitive*** *ratings to this transaction. The definitive ratings may differ from the* ***prospective*** *ratings set forth in this report. Moody's will disseminate the assignment of definitive ratings through its Client Service Desk.*

TRANSACTION IN BRIEF:

	Class A	Class B
Rating:	(P)**Aaa**	(P)**A2**
Amount:	£[90%]	£[10%]
Coupon:	Libor + [•]bps	Libor + [•]bps
Step Up Date:	May 2007	May 2007
Step Up Margin:		
Final Maturity:	August 2031	August 2043

Interest Payment Dates:	7th day in February, May, August and November
Issuer:	Paragon Mortgages (No.3) PLC
Originator:	Paragon Mortgages Limited
Servicer	Paragon Finance PLC
Servicer of Last Resort:	Global Homeloans Limited
Trustee:	Citicorp Trustee Company Limited
Lead Manager:	Barclays Capital
Asset Characteristics:	First residential mortgages to individuals and corporates in England, Wales and Scotland

Summary of Provisional Pool (as at 12 April 2001):

Count:	3,832 residential loans
Prin. Amt:	£235,105,000
LTV:	Avg: 75.96%; 90-95%: 0.12%; 95-100%: 0.02%; 100+%: 0%
Loan Size:	Avg: £61,353; Max: £501,000
Performance:	**Current**: (inc <=1 month arrears) 99.46% **Arrears**: 1-3 months 0.29%; 3-6 months 0.20%; 6+ months 0.05%
Loan Usage:	Purchase 57.1%, Remortgage 42.9%
Interest Rate:	Paragon Variable Rate 24%; Capped 0.01%; LIBOR-linked 40.3%; Fixed Rate 36.0%
Concentration:	North 3.0%; N.West 8.6%; Yorks 9.7%; E.Midlands 3.9%; W.Midlands 5.3%; E.Anglia 3.9%; S.East 30.8%; S.West 10.6%; G.London 18.2%; Wales 4.7%; Scot 1.4%
Seasoning:	1998 0.1%, 1999 0.5%, 2000 80.9%, 2001 18.5%
Mtg Indem. Ins:	Heath Lambert Insurance Service Ltd (0.9% of the portfolio is covered by MIG insurance)
Credit Support:	First Loss Fund (2.0% of the initial balance of the mortgages and the Pre-Funding Reserve), the Class B Notes and Excess Spread.
Launch Date:	[•] 2001

RATING OPINION

Moody's has assigned prospective long term credit ratings of (P)**Aaa** to the Class A Notes and (P)**A2** to the Class B Notes of the Issuer.

Moody's issues prospective ratings in advance of the final sale of securities, and these ratings only represent Moody's preliminary opinion. Upon a conclusive review of the transaction and associated documentation, Moody's will endeavour to assign definitive rating to the Notes. A final rating may differ from a prospective rating.

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

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

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

Structure

Purchase of Mortgage Loans

The Issuer used the Note proceeds:

1. To purchase a portfolio of UK residential mortgage loans originated by Paragon Mortgages Limited ("PML");
2. To make a loan to Paragon Mortgages (No.4) SA ("PSA4"), an insolvency remote special purpose company incorporated in Luxembourg, which in turn purchased a further portfolio of UK residential mortgages originated by PML; and
3. In funding the initial balance of the Pre-Funding Reserve, which is a reserve fund to be used to purchase further mortgage loans up to and on the first Principal Determination Date.

The Issuer utilised the proceeds of a subordinated loan from Collateralised Mortgages (No. 5) PLC ("CMS5") to meet the start-up costs and to fund the £[6.8]M First Loss Fund.

The mortgage loans purchased by PSA4 are mortgage loans made to corporates and the purpose of the PSA4 loan structure is to eliminate the potential imposition of UK withholding tax that would otherwise fall due on payments to the Issuer from corporate borrowers had it purchased the loans directly. Borrowers are able to rely on the UK/Luxembourg double tax treaty to remove the need to withhold on payments under the loans. Under Luxembourg law, payments made under the loan back into the UK by PSA4 to the Issuer can be made free from withholding tax. The Luxembourg arm of the transaction, PSA4, will be collapsed should Royal Assent be received on the legislation to abolish Withholding Tax announced in the budget on 7 March 2001.

Moody's is concerned that this arrangement could be attacked on anti-avoidance grounds by either the UK or Luxembourg tax authorities, but is satisfied that these risks are sufficiently mitigated by the following:

1. Advice has been given by the transaction's accountants that the amount of the withholding would be limited to 20% of the interest payable with respect to 16.1% (the proportion of corporate loans in the deal) of the portfolio balance, which amounts would ultimately be recoverable from the UK revenue by the Issuer. Accordingly, the impact of an imposition of withholding tax would be of a liquidity rather than a credit nature;
2. The same advice also confirms that, if UK withholding tax was to be imposed, the UK Revenue would have recourse to the related borrower and not against the Issuer should it attempt to recover amounts that should have been withheld as the obligation to withhold is an obligation of the borrower; and
3. Paragon and its advisors have received a letter from the UK tax authorities stating that interest payments received by PSA4 from borrowers under the mortgages will not be subject to withholding tax. This was also the case with the previous 'Paragon Mortgages' transaction.

PSA4 has created security over all its assets in favour of the Issuer as security for the repayment of the loan made to PSA4. The Issuer has also created fixed and floating security over all its assets including the mortgage loans purchased directly by it, and its rights under the loan made to PSA4 and the security granted to it by PSA4. Opinions in relevant jurisdictions confirm the validity of these arrangements.

Ownership of Issuer

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

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

VAT Grouping

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

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

PSA4 is not a member of the Paragon VAT Group.

Collateral

The most distinctive feature of recent transactions from Paragon has been the high proportion of mortgage loans secured on let, as opposed to owner occupied, properties. These amount to 94.5% of the principal balance of the loans in the collateral pool supporting this deal. Although Moody's believes that the performance of these types of products may exhibit more volatility over the economic cycle, we are comfortable with the transaction for the following reasons;

1. The strong underwriting and origination procedures used by Paragon Mortgages Limited ("PML");
2. The strong performance of prior loans secured on let property previously originated by PML. The arrears and losses observed in recent Paragon securitisations have been much lower than in most prime mortgage backed transactions from major mortgage originators;
3. The moderate LTV levels in the pool; and
4. The level of credit enhancement available in the deal.

The average LTV of 76% is slightly higher than the previous Paragon transactions and compared to the enhancement in the previous transaction, the first loss fund has reduced from 2.7% to 2.0%. However, the transaction benefits from any excess spread in the deal. Paragon have pledged to maintain the gross margin in the deal at a minimum level of 1.60% until the Note step up date, and 2.00% thereafter, or to inject additional funds into the transaction

Credit Enhancement

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

Excess Spread and the MMR

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

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

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

The transaction benefits from a Minimum Mortgage Rate ("MMR") which provides some guarantee as to the amount of Excess Spread that will be available; under the MMR, the Administrator must set the rate on the variable rate mortgages in the portfolio so as to ensure that the weighted average interest of the portfolio taken as a whole plus any other income received by the Issuer is at least 1.60% in excess of the Libor rate applicable to the Notes, although there is an option for the Issuer to borrow further amounts under the subordinated loan made by CMS5 so as to cover the shortfall that would result absent the MMR.

However, the credit enhancement value of the MMR, and the Excess Spread that it generates, depends on a number of factors such as relative prepayment speeds of the various loan types in the portfolio; should the variable rate loans (including the Libor-linked loans), which make up 64% of the portfolio, prepay more quickly, then the portfolio would be dependent on an increasingly small number of variable loans generating sufficient revenue to cover any shortfall arising with respect to other loan-types (such as fixed and capped rate loans) in the portfolio. Moody's has analysed the likelihood of adverse prepayment speeds and is satisfied that the residual risk is consistent with the rating levels, especially given that the majority of fixed and capped rate mortgage loans revert to a variable rate after a fixed initial period of up to 3 years.

The credit enhancement value of Excess Spread also depends on the timing of principal losses. Excess Spread is available on a “use it or lose it” basis and so, if not used to top up the First Loss Fund or to reduce the Principal Deficiencies Ledger, it is paid back to CMS5 and PFPLC via the Subordinated Loan and other profit extraction mechanisms; which might occur before losses on the portfolio have shown through. The value of the Excess Spread was assessed by Moody’s under a variety of adverse conditions.

First Loss Fund

The second layer of protection for investors in the Notes is the First Loss Fund (equal to 2.0% of the initial current balance of the portfolio and the Pre-Funding Reserve (see below)). This fund is available to pay interest and senior cost obligations of the Issuer should there be insufficient spread on the assets to meet these obligations. The fund is topped up, in priority to the elimination of any principal deficiencies on the Principal Deficiency Ledger until all the Class A Notes are redeemed, using Excess Spread. The required balance of the First Loss Fund may be reduced with Moody’s agreement and may amortise after May 2006 in line with the mortgage collateral so that it equals 4.0% of the current principal balance of the outstanding mortgage pool, but only if (a) there is no debit balance on the PDL, and (b) less than 6% of the pool by principal balance is more than 3 months’ in arrears. Moody’s believes that these are very strict tests to meet.

Principal Subordination

The third layer of protection for investors is the subordination of the principal balance of the B Notes to the A Notes. The Class A Notes redeem sequentially but begin to redeem pro rata with the Class B Notes after 5 years but only if:

1. The ratio of Class B Notes to Class B Notes and Class A Notes is at least twice the ratio calculated as at closing;
2. There is no debit balance on the PDL;
3. Less than 10% of the pool by principal balance is 3 or more months in arrears; and
4. Pro rata redemption would not cause the principal balance of the Class B Notes to fall below £[16]m.

Interest/Interest Subordination

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

Interest/Principal Subordination

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

Liquidity

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

Principal Paying Interest

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

First Loss Fund

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

Liquidity Facility

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

Pre-Funding

Part of the proceeds of the Notes will be retained by the Issuer and will be used to purchase a further tranche of mortgage loans, and/or to make a further advance under the Luxembourg Loan to allow PSA4 to purchase further loans, on or prior to the first Principal Determination Date. However, before further loans can be included within the transaction in this way, Moody's must confirm its ratings of the Notes. Any amounts that are retained for Pre Funding will, to the extent not applied in the purchase of further loans, be applied in redemption of the Notes on the first Interest Payment Date.

Accrued Interest

The Issuer will purchase all loans made to individuals which are "current" as at purchase date at par and the amount of all interest and arrears as at purchase date will be retained by PML. Loans which are not current and which are loans to individuals will, however, be sold at par plus the amount of all interest and arrears as at the purchase date. PSA4 will purchase all loans which are loans to corporates at par plus the amount of all interest and arrears as at the purchase date. The transaction structure provides for this to be repaid as follows: each payment received will be treated as first representing accrued interest and arrears, then current interest and finally principal. It is a term of the transaction that, should the rate at which such interest and arrears amounts are collected fall below Moody's expectations, Moody's may specify that the First Loss Fund is to be increased to a higher amount in order to mitigate this risk.

Collections and Bank Accounts

The vast majority of payments under the Loans are collected by PML under the direct debit scheme. All receipts in respect of the loans will be paid directly into the PML collection account, and will be held on trust for the Issuer or PSA4 pending transfer into the transaction account of the Issuer or PSA4 as appropriate. These transaction accounts are dedicated accounts of the Issuer and PSA4 held with National Westminster Bank Plc (**Aa2**, **Prime-1**). Cash in the transaction accounts must be invested by Paragon Finance Plc as administrator in eligible investments which meet certain criteria, including a requirement that the investments are rated either **Aaa** or **Prime-1** and mature prior to the next interest payment date.

Interest Rate Risk

The mortgage loans either charge interest at a variable rate set by PML (24% of the pool), or by reference to 3 month Libor (40% of the pool) or at a (temporarily) fixed or capped rate (36.0% of the pool), whereas payments under the Notes are to be calculated by reference to 3-m sterling Libor. The MMR mechanism described above partially mitigates this risk because it ensures that weighted average rate received by the deal exceeds Libor under the Notes plus the relevant margins. However, as mentioned above, the protection afforded by this mechanism is susceptible to a number of factors such as relative prepayment speeds of the various loan types in the portfolio.

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

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

Conversion

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

Further Advances

The Issuer may use principal receipts from the mortgage portfolio to make further advances to the mortgage borrowers, but the cumulative amount of further advances is subject to a cap of £50m, and is also conditional on the Issuer's continued compliance with various contractual restrictions contained in the transaction documents. In addition, if Moody's indicates to the Issuer that the making of additional Further Advances will result in a downgrade of the Notes, then, unless the First Loss Fund is increased to a level such that Moody's confirms the ratings of the Notes will not be downgraded if additional Further Advances were to be made, the Issuer will no longer be entitled to make Further Advances.

Servicing

Paragon Mortgages Limited, the seller and originator of the loans, is a wholly owned subsidiary of Paragon Finance PLC, the transaction's mortgage administrator. Moody's believes that Paragon has a well developed servicing business with a track record of successful collections and arrears management in the United Kingdom. In addition, [Global Home Loans Limited], is the servicer of last resort.

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