RMBS / UK
Presale Report

Paragon Mortgages (No. 6) PLC

Expected Ratings*

Class	Amount (m)	Final Maturity	Rating	CE (%)
A1 GBP Equivalent 200 million				
A1	USD [ ]	2004	F1+	12.7
A1R	GBP [ ]	2030	AAA	12.7
A2 GBP Equivalent 385 million				
A2a	USD [ ]	2030	AAA	12.7
A2b	GBP[ ]	2030	AAA	12.7
A2c	EUR [ ]	2030	AAA	12.7
B1 GBP Equivalent 65 million				
B1a	USD [ ]	2042	A	2.7
B1b	GBP [ ]	2042	A	2.7
B1c	EUR [ ]	2042	A	2.7

Analysts
Fionnuala Connolly
+44 20 7417 4354
fionnuala.connolly@fitchratings.com

Suzanne Albers
+44 20 7417 6325
Suzanne.albers@fitchratings.com

Stuart Jennings
+44 20 7417 6271
Stuart jennings@fitchratings.com

Surveillance
Antje Mayer
+44 20 7417 4335
sf_surveillance@fitchratings.com

*Expected ratings do not reflect final ratings and are based on information provided by the issuer as of 31 July 2003.

■ Summary

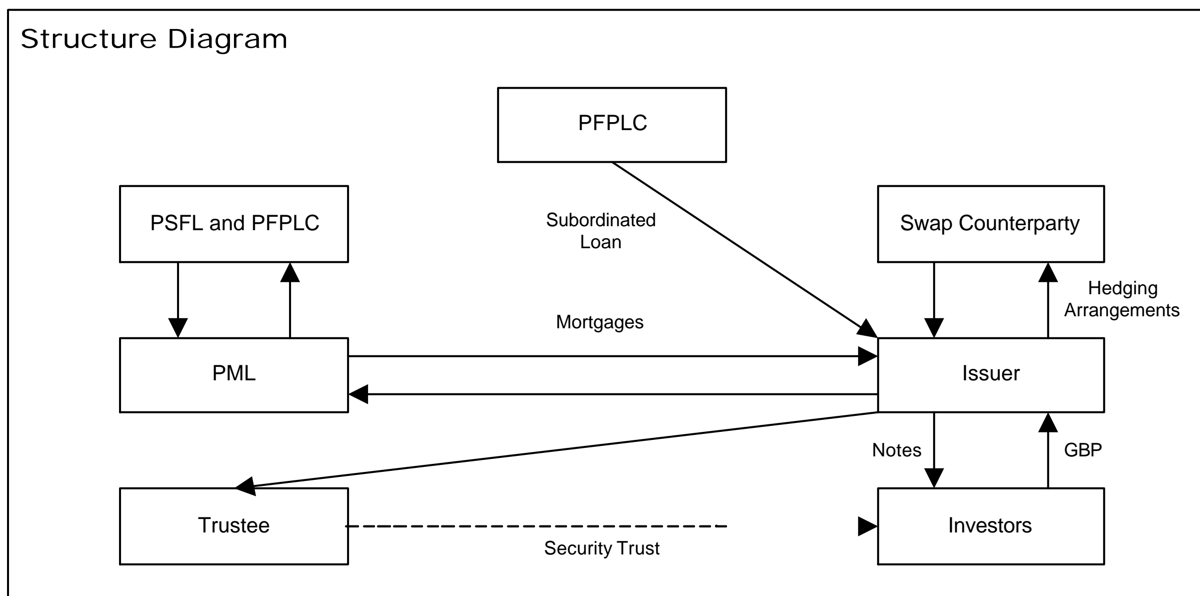
This GBP650 million equivalent transaction is a securitisation of residential mortgages originated in the UK. Fitch Ratings ("Fitch") has assigned expected ratings to the notes to be issued by Paragon Mortgages (No. 6) PLC (the "issuer" or "PM6") as indicated at left. The reference portfolio consists entirely of buy-to-let mortgages originated by Paragon Mortgages Limited ("PML").

The expected ratings are based on the quality of the collateral, available credit enhancement, the underwriting processes of PML and the servicing capabilities of Paragon Finance PLC ("PFPLC": both PFPLC and PML are wholly-owned subsidiaries of The Paragon Group of Companies ("the Group")), and of Global Home Loans Limited ("GHLL"), the sound legal structure of the transaction and, in the case of the A1 notes, the credit standing of the purchasing counterparty, Sheffield Receivable Corporation ("Sheffield"), a Barclays Bank PLC sponsored, asset-backed commercial paper (ABCP) conduit (the "A1R Subscriber"), consistent with the 'F1+' rating assigned to the A1 notes. Credit enhancement for the Class A1 and A2 notes will be provided by the subordination of the Class B1 notes (10%) and a reserve fund of 2.7%, which will be fully funded at closing. The reserve fund will further build up to 3.4% upon the occurrence of certain arrears triggers.

In the context of residential lending, PML specialises in the origination of buy-to-let loans to "professional" landlords, defined as borrowers with at least 12 months' experience managing at least three rental properties. All of the loans in the reference portfolio are secured on investment properties belonging to such borrowers.

The Group offers an array of financial products, ranging from personal, retail point of sale and auto loans to prime residential mortgages. It has completed 40 securitisations to date (the majority being residential mortgage transactions). This is the Group's sixth in the Paragon Mortgages series.

To determine appropriate credit enhancement levels, Fitch analysed the collateral using its UK Residential Mortgage Default model as a benchmark and adjusted it to account for additional risks associated with buy-to-let lending (see research "*UK Residential Mortgage Default Model II*" of 13 October 2000, available on www.fitchratings.com). Fitch also modelled the cash flow contribution from excess spread using its European RMBS Cash Flow Model (see research "*European RMBS Cash Flow Criteria*" of 20 December 2002, available on www.fitchratings.com) using the default and recovery assumptions indicated by the default model. The cash flow test showed that each class of rated notes could withstand loan losses at a level corresponding to the related stress scenario without incurring any ultimate principal loss or interest shortfalls on interest payment dates.



Special Reports

The following special reports provide additional detail on the Fitch rating approach to, and performance of, the RMBS market, each available at www.fitchratings.com:

- *UK Residential Mortgage Default Model II*
- *A Guide to Cash Flow Analysis for RMBS in Europe*

Credit Committee Highlights

- The portfolio consists entirely of buy-to-let loans. Fitch believes that, ceteris paribus, an investment property borrower will be more likely to default on a mortgage obligation in a downturn than a borrower whose loan is secured on his or her home. However, in mitigation, most of the Paragon borrowers are considered "professional" landlords, with a proven history of maintaining a portfolio of investment properties.

- There is a degree of "granularity" in the pool owing to clusters of properties in certain districts favoured by "professional" landlords.

- It is possible that a single "professional" borrower could accumulate upwards of 20 mortgage loans from PML, each backed by a property and a corresponding stream of rental income. Whilst this represents an increased exposure to a single obligor, the normal evolution of an investment portfolio over time means that all its constituent loans are unlikely to find themselves in a single securitisation issue. Furthermore, PML has had some historical success in setting off delinquencies on one loan with surplus income generated by properties within the same borrower's investment portfolio.

- Arrears levels for Paragon's mortgage portfolio are currently well below those of prime portfolios and of the rest of the buy-to-let sector (based on Council of Mortgage Lenders arrears data). Fitch has therefore given more credit to Paragon's ability in terms of loan underwriting and the quality of its arrears management.

- Fitch continues to stress the portfolio's default rates beyond those for a prime owner-occupier portfolio at all ratings levels, despite the current low level of arrears. This stress addresses the relative youth of, and lack of historical track record in, the UK buy-to-let sector in general, as well as addressing some concern surrounding potential oversupply of buy-to-let property, particularly in London and the South East.

- The Class A1 notes will have a final legal maturity of September 2004. The A1R Subscriber has contracted to fund the outstanding balance of the Class A1R notes at this time via the Class A1R Note Purchase Agreement, to be issued at closing, partially paid. Proceeds will be used to redeem the A1 notes at their maturity. Redemption of the Class A1 notes at their final legal maturity, and, therefore, the rating of the notes, is dependent upon the creditworthiness of the A1R Subscriber. Should the A1R Subscriber fail to meet its obligations, then it is possible that the A1 notes could default if there have been insufficient loan redemptions to redeem them

Key Information – Structure

Issuer: Paragon Mortgages No 6 PLC (PM6).

Lead Managers: Barclays Capital and Royal Bank of Scotland.

Originator: Paragon Mortgages Limited (PML).

Trustee: Citicorp Trustee Company Limited.

Paying Agent: Citibank N.A..

Mortgage Administrator: Paragon Finance PLC.

Special Servicer: Paragon Finance PLC.

Standby Mortgage Administrator: Global Homeloans Ltd (GHL).

Cash/Bond Administrator: Paragon Finance PLC Basis Hedge Provider: JP Morgan Chase Bank (rated Long-term 'A+'/Short-term 'F1').

Currency Swap Provider:[TBA] (rated Long term [ ] Short term [ ]).

Class A1R Subscriber: Sheffield Receivables Corporation.

Account Bank: National Westminster Bank (rated Long-term 'AA+'/Short-term 'F1+').

Interest Payments: Quarterly in arrears for Class A1R, A2 and B1 notes, starting on 15 December 2003 and thereafter on the 15th day of March, June, September and December in each year. Interest on the Class A1 notes will be paid monthly, starting on 15 November 2003 and on the 15th day of each month thereafter.

Legal Maturity: For the A1 notes, September 2004; for the A1R notes and A2 notes, March 2030; and for the B1 notes, September 2042.

Optional Redemption: At [September 2006] or step-up date in September 2007 or any payment date thereafter, or clean-up call at 20% or less of original principal.

prior to their legal final maturity. Backup liquidity is, however, provided to the A1R Subscriber by Barclays Bank and Royal Bank of Scotland.

- As at closing, 15.4% of the principal raised through the note issuance will be retained in the transaction account and applied on the first principal determination date towards the purchase of further loans (pre-funding). This retention of funds will result in a lower return than if the funds were invested in higher-yielding mortgages, therefore creating negative carry for the transaction during the first interest period. This first period will only, however, be for seven weeks.

Key Information

Provisional Pool Characteristics

Total Amount: Approx GBP 489.4 million (5,768 loans)

WA Current LTV: 80.7%

WA Current Interest Rate: 5.22%

WA Remaining Maturity: 265 months

WA Seasoning: 4 months

Interest Only Mortgages: 81.9%

■ Credit Structure

The financial structure of the transaction is designed to provide differing degrees of credit enhancement to the note tranches. The Class A1 and A2 notes are protected firstly by any excess spread, secondly by the reserve fund (2.7%) and thirdly by the subordination of the junior tranche (10%). The Class B1 tranche is supported firstly by any excess spread and secondly by the reserve fund.

The reserve fund will also be available to cover interest shortfalls and losses, subject to certain restrictions on paying interest on the junior notes (see 'Reserve Fund' below). The reserve fund will increase further to 3.4% in the event that a certain level of arrears is exceeded.

Available residual excess spread is used to replenish the reserve fund (if drawn) to its required amount on every payment date before the remainder returns to the originator.

The Class A1 notes will have a final legal maturity of September 2004. The Class A1R notes will be issued at closing partially paid. Under the Class A1R Note Purchase Agreement, the A1R Subscriber is contracted to fund the outstanding balance of the A1R notes up to the then current amount of the outstanding A1 notes, the proceeds being used to redeem the A1 notes.

The redemption of the Class A1 notes at their legal final maturity, and therefore the rating of the notes, is dependent upon the creditworthiness of the A1R Subscriber at that time, currently consistent with the 'F1+' rating awarded to the Class A1 notes.

Revenue Priority of Payments

Payments received by PM6 are split into revenue and principal and are, subject to certain exceptions (see Principal Used for Senior Interest Liquidity), paid via separate waterfalls. All revenue received on the issue (e.g. borrower interest payments, revenue swap payments and interest earned on cash in the collections accounts prior to the interest payment

date) will be applied on each payment date in the following priority of payments;

1. Trustee and substitute servicing fees.
2. Servicer fees.
3. *Pro rata*, amounts due and payable (i) under the basis and currency swap agreements and (ii) as interest to the Class A1, A1R and A2 noteholders.
4. Interest due and payable on the Class B1 notes.
5. Issuer VAT to be paid, if any.
6. Amounts applied in extinguishing a debit balance on the principal deficiency ledger (PDL).
7. Amounts required to replenish and/or build up the reserve fund and first loss fund.
8. Other subordinated amounts, including a provision for a reserve to fund any purchase of caps or other hedging instruments in the next period.

Should the debit balance recorded on the PDL exceed the balance of then outstanding Class B1 notes, items (4) and (5) will be relegated below item (6) to the extent of any excess. This ensures that any PDL debit balance corresponding to the Class A1, A1R and A2 notes will be reduced to zero prior to the payment of interest on the Class B1 notes.

Principal Used for Senior Interest Liquidity

Principal receipts may be used to pay interest on the Class A1, A1R and A2 notes in the event that it cannot be paid from excess spread and amounts in the reserve fund. The PDL will be debited by the amount used to pay senior interest. This debit balance will then be repaid at the relevant position in the revenue priority of payments using available revenue.

Principal Redemption

Mandatory

All amounts recorded as principal (including scheduled repayments, prepayments, amounts credited to the PDL and defaulted loan sale proceeds) other than in respect of senior interest shortfalls not covered by revenue funds, or further advances extended during the previous period, will initially be passed through to noteholders sequentially. However, provided that:

- the A1 and A1R notes have been fully redeemed;
- the balance of junior notes as a proportion of the total outstanding balance of notes exceeds two times that at closing;
- it is after September 2008;
- there is no debit balance on the PDL;
- the balance of loans in arrears for over three months is less than 7.5% of the then current balance; and
- the outstanding balance of Class B1 notes is greater than GBP31 million,

then amortisation will be pro rata in order to maintain the ratio of B1 notes to senior notes that exists at that time.

Optional

At the option of the issuer it is possible to redeem all of the Class A1, A1R and A2 and B1 notes at their respective outstanding principal amounts plus accrued interest in the following circumstances:

- on the interest payment date in [September 2006] and on or after the step-up date in September 2007;
- if the then current outstanding principal amount is less than 20%; and
- if the issuer is required to make any withholding tax deductions.

Fitch's ratings do not address the possible exercising of these call options held by the issuer.

Final

To the extent not previously paid down, the Class A1, A1R, A2 and B1 notes are due to be redeemed in full in 2004, 2030, 2030 and 2042 respectively.

Interest Rate and Basis Risk

At closing, 18.7% of loans will have a fixed rate of interest for a specified period lasting until, at the latest, April 2013. While only a few of these will remain fixed-rate loans after July 2008, the possibility of variable-rate loans subsequently being converted into fixed-rate loans may account for a higher number of fixed-rate loans existing in the portfolio after this date.

In order to hedge its exposure to fixed and capped rate loans in a rising LIBOR (London Interbank Offered Rate) environment, the issuer will enter into a master interest rate exchange agreement with JP Morgan Chase Bank. Any increase in this exposure will be accompanied by a suitable extension of the hedging arrangements, funded from excess spread trapped in a subordinated position in the revenue priority of payments on the previous payment date.

Of the total portfolio, 73.2% generates interest, which is referenced from three month GBP LIBOR. The remaining 8.1% is charged interest based on PML's standard variable rate (SVR), which itself can be based on three month LIBOR or Bank of England Base Rate. To the extent that the mortgage interest

rates have different reset dates to those of the notes, incremental additional costs may be incurred by the issuer, which in the first instance will reduce excess spread income.

In addition to the hedging arrangements, Paragon has a threshold interest margin mechanism in this transaction designed to ensure that the weighted average contractual margin over three month LIBOR on the reference portfolio as a whole will be at least 1.6%, rising to 2% after September 2007. Should the weighted average margin fall below these levels, the mortgage Administrator will, under the mechanism, be obliged to increase the SVR on the pool or ensure that there are sufficient funds in the shortfall fund to maintain the minimum level. Fitch has stressed the threshold interest margin rate that is achievable below this in its 'AAA' analysis.

Currency Risk

The Issuer will enter into currency swaps to hedge the currency mismatches between the GBP-denominated assets and the USD and EUR note liabilities of some of the note classes. The currency counterparty must be rated at least 'F1' by Fitch. In the event of a downgrade of any counterparty below this level, the counterparty will be required to collateralise any exposure, obtain a guarantee from a suitably rated counterparty or find a suitably rated replacement provider.

Prefunding

The issuer has the right to purchase further mortgages on 28 November 2003 (the first principal determination date), using funds set aside at closing from the proceeds of the notes and credited to the prefunding ledger. Fitch must confirm that any prefunded loans will not adversely affect the rating of the notes before they are included within the portfolio. At the first interest payment date, any balance that remains to the credit of the prefunding ledger, which was not used to purchase mortgages, will be used to pay down the notes. Any loans purchased both at closing and on the prefunding date must have "verified" (that is, made their first payment due).

Credit Enhancement and Liquidity

Reserve Fund

The reserve fund of GBP17.55 million (2.7% of the issue) will be fully funded at closing via a subordinated loan advanced by Paragon Salvage Recovery (No.2) Ltd. ("PSR2"). The reserve fund will further increase to 3.4% in the event that arrears in excess of 60 days exceed 3% of the portfolio.

Any drawings of the reserve fund (to cover losses or revenue shortfalls) will be replenished using available excess spread. The fund has been sized by Fitch to ensure that the notes have sufficient credit protection and liquidity support to merit their respective ratings.

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 ongoing 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, an effect that 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 would be further compression of excess spread. Furthermore, high prepayment rates on the portfolio as a whole would squeeze the gross amount of credit enhancement available over the course of the transaction. To take account of these factors in its cash flow modelling, Fitch applied its performance assumptions (derived from the collateral model) in conjunction with stressed prepayment rates and a compressed weighted average coupon according to rating scenario (Fitch's approach to modelling cash flow in RMBS transactions is further discussed in Appendix One and in the criteria report "A Guide to Cash Flow Analysis for RMBS in Europe" dated 20 December 2002 and available at www.fitchratings.com).

Collateral Analysis

The provisional pool analysed consisted entirely of prime residential buy-to-let mortgage loans with a total outstanding balance of approximately GBP489.4 million (as at 31 July 2003). On or before the first principal determination date of 28 November 2003, further loans will be purchased using the retained prefunding amount. Fitch has highlighted below the distinguishing characteristics of the portfolio, with commentary on any special considerations (all percentages are based upon the current balance of mortgages unless otherwise stated).

Buy-to-Let

All of the loans in the portfolio are buy-to-let loans. Fitch applies an additional default hit to these to reflect the fact that:

- 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.

However, Fitch notes that whilst the minimum required debt service coverage ratio ("DSCR", expressed as rental income against mortgage repayment) is 120%, an analysis of Paragon's warehouse file as at June 2003 indicated that 97.9% of recent loan originations by value have DSCR ratios above 130%, while 39.3% by value have DSCR ratios above 200%. This would suggest that borrowers are protected to some degree from a potential reduction in rents.

Fitch notes too that the majority of borrowers in this portfolio are "professional" landlords, with a minimum of 12 months' experience of managing at least three properties and with a recognised aptitude in enforcing tenancy contracts. This assists in minimising any downtime between tenancies. Another mitigating feature of buy-to-let loans in general is that upon default, the foreclosure process is likely to be quicker than in other cases, as tenants with shorthold tenancy agreements can generally be more easily evicted than owner-occupiers or the lender can receive the rental income directly. For a more detailed commentary, please refer to Origination below.

Repayment Type

Interest-only mortgages account for 81.1% of the pool. Fitch applies a default stress to these loans, which reflects the increased risk of default at maturity due to the risk that the borrower may be unable to refinance the loan at this time.

Arrears Loans

In the provisional pool, 0.14% of loans by current balance are currently more than 30 days in arrears, of which 0.03% are over 90 days in arrears. Fitch assumes that loans in arrears are more likely to go into default, and applies more conservative default adjustments to these.

Interest Rate Type

By current balance, 18.7% of loans are fixed-rate for a pre-specified period, after which they revert to variable-rate. All the fixed-rate loans in the provisional pool will have reverted at the latest by April 2013. While this may lead to a minor payment shock, Fitch does not believe that this warrants any special adjustment to default probabilities. Of the total portfolio, 71.8% generates interest, which is referenced from three month GBP LIBOR, while the remaining 8.1% is charged interest based on PML's standard variable rate (SVR), which itself can be based on three month LIBOR or the Bank of England Base Rate.

The ratio of fixed- to variable-rate loans may change not only as a result of periods expiring, but also following the approval of borrowers' requests by the Administrator to convert their mortgages: see 'Interest Rate and Basis Risk' above.

Conversion

Subject to certain conditions, the Administrator may approve borrower requests to convert certain aspects of their mortgages, for instance from a variable-rate loan to fixed or capped. To approve this change, the issuer would have to obtain the necessary cash in advance in order that it would be in a position to extend the then current hedging facilities. This would be achieved either by trapping excess spread in advance or by obtaining a loan from PSR2, whose subsequent claim would be in a subordinated position in the revenue waterfall.

Further Advances

Certain borrowers in the pool have the right to obtain a further advance upon the completion of construction works or refurbishment to their properties. Other 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:

- there was no debit balance on the PDL as at the previous interest payment date;
- the aggregate of (i) the issuer's maximum potential obligation – at closing – to fund mandatory further advances, and (ii) the maximum balance of discretionary further advances made or being considered, is less than GBP105 million;
- the reserve fund is at its required amount;
- in respect of discretionary further advances, the borrower has not been in arrears in the previous three months or in breach of the mortgage conditions; and
- the weighted average current loan-to-value of the portfolio would not exceed its value at closing by more than 1%.

■ Legal Structure

The PM6 legal structure is designed to ensure that a seller insolvency would not interrupt timely payments of principal and interest to investors.

On the closing date, the loan seller will assign the rights, title and interest in and to the mortgages to PM6 (a public company incorporated under the laws of England and Wales). There will be no recourse to the seller so that the transfer to PM6 will be treated as a true sale.

At closing, PM6 will enter into a deed of charge, creating security over the collateral in favour of the trustee as security for all payments under the notes. The security includes first lien mortgages and first fixed charges in favour of the trustee on all the Issuer's rights, claims, title, benefit and interest in and to the underlying collateral.

Representations and Warranties

The mortgage sale agreement contains representations and warranties given by the originator in relation to the pool of mortgages. No search of title will be conducted by the issuer or the trustee; rather, they will rely on 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 constitutes a first ranking legal mortgage, which is a valid and binding obligation of the borrower, enforceable under its terms.
- No lien or right of set-off exists between the borrower and the originator.
- Each loan has been underwritten according to the originator's lending criteria outlined in the offering circular. This includes proper investigation and search of the relevant properties.
- Prior to granting the loan, a property valuation was conducted by Paragon's in-house valuers or an independent valuer from the panel of valuers appointed by the originator.
- Each loan governed by the Consumer Credit Act 1974 meets the requirements of the Act in full.
- The maximum aggregate principal amount of arrears mortgages which may be purchased as at the date of purchase is GBP1.5 million.
- At its date of completion, each property was insured under a buildings policy or a block buildings policy.
- All loans were originated by PML.
- All loans have received their first payment instalment.

Origination and Servicing

Origination

PML is a subsidiary of The Paragon Group of Companies, a group specialising in the provision of various financial products to consumers. As a mortgage company, PML specialises in the origination of buy-to-let products, and since February 2001, the vast majority of originations have been to so-called "professional" borrowers. To qualify for the benefits of such a loan – notably a higher LTV – a borrower must already possess a portfolio of at least three properties and must present at least 12 months of 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. PML insists that expected rental yields must exceed 120%, and ordinarily 130%, of the mortgage repayments on an interest-only basis. Paragon stresses interest rates to its standard Lettings Variable Rate for the purposes of this test.

PML has five levels of underwriting based on a hierarchy of mandates. To increase borrowings above these levels, Paragon may request additional information, such as a business plan or performance data, or may conduct an interview with the applicant. Large exposures – i.e. in excess of GBP1 million – to single borrowers are monitored via an annual review of accounts, letting conditions, voids, demand, and cash flows, as well as a consideration of the borrower's strategy for the next 12 months. These controls are designed to ensure that PML is kept abreast of the performance of key borrowers' portfolios, and may militate against single obligor concentration within the reference portfolio.

As with other buy-to-let lenders, PML prefers to retain human discretion in its lending procedures rather than adhere to a pro forma approach, and, as such, a hierarchy of mandates adhering to guidelines and criteria ensures that accountability is maintained. At the heart of policy-making is the overarching credit committee – comprising four standing members, department heads and other experts – which convenes on a monthly basis and which presides over any changes to criteria and special cases. Voting by department heads is restricted to departments other than their own, a segregation of duties that helps to prevent "relationship-lending" factors influencing credit decisions.

"Professional" landlords are believed to be more adept than standard borrowers 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. This assertion is based on the time and energy that "professional" landlords are able to spend administering their portfolio and researching the market.

Servicing

PFPLC is responsible for administering the mortgage loans in the reference portfolio. It invested in sophisticated collections technology following the adverse credit experience suffered by the Group in the early 1990s. In a self-contained site at the Group's West Midlands base, 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.

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 requires that adequate arrangements are in place to ensure continued servicing in the event that the named servicer in a transaction is unable to perform its duties.

This transaction features a standby servicer, Global Homeloans Limited (GHLL), a subsidiary of Countrywide Credit Industries, Inc., and the largest third party servicer in the UK, with over GBP32 billion of loans in administration. GHLL is contractually required to assume servicing responsibilities in the event that Paragon is no longer able to continue servicing the portfolio.

■ Performance Analytics

Fitch will monitor the transaction on a regular basis and as warranted by events. Its structured finance surveillance team ensures that the assigned ratings remain, in the agency's view, an appropriate reflection of the issued notes' credit risk.

Details of the transaction's performance are available to subscribers at www.fitchresearch.com. Further information on this service is accessible at www.fitchratings.com.

Please call the Fitch analysts mentioned on the first page of this report for any queries regarding the initial analysis or the ongoing surveillance.

Appendix 1 – Rating Methodology

Model Approach

To determine loss coverage for RMBS, Fitch's default model employs a loan-by-loan review, examining several loan-, borrower-, lender- and property-specific factors that most influence default probability and loss severity. Fitch's base default probability analysis focuses primarily on the borrower's income multiple, in conjunction with the loan's LTV. These expected default rates are then adjusted further by loan, borrower, lender and property attributes. A large component of Fitch's loss severity analysis is market value trends. Fitch's market value assumptions focus on historical regional volatility and sustainable growth. Market value projections are then adjusted by loan and property attributes.

Default Probability Adjustments

Underwriting and Servicing Quality: When applying the default probability matrix, Fitch also considers a lender's underwriting and servicing guidelines. Fitch's views will be formed following a due diligence visit, where the lender's criteria and procedures regarding borrower income, LTV, borrower's past credit performance and many other factors will be considered. Fitch's review and analysis of the originator determines whether it decreases base default rates by up to 25% or increases them by up to 250%.

Investment Properties: Fitch's methodology in evaluating the default probability of a Buy-to-let (BTL) portfolio is to use the UK residential default model, but with the following additional assumptions:

- For the base probability of default, BTL loans are assigned an affordability class based on underwriting criteria related to the minimum interest cover requirement. Generally speaking, Fitch will assign a high affordability class (meaning less affordable and thus a higher base probability of default) unless rental yields are estimated to exceed 150% of the mortgage payment, including principal, and are tested at a stressed interest rate.
- A loan-by-loan increase in base default probabilities by 25% for the fact that the properties are non-owner occupied.
- Increase in the underwriting quality factor to account for lack of experience in BTL. This factor also incorporates originator-specific issues related to underwriting criteria, historical experience as well as servicing capabilities.

Repayment Types

The most common repayment types in the UK market are repayment and interest-only mortgages. Interest-only mortgages are usually linked to some form of investment vehicle: either an endowment policy, a pension or Individual Savings Account (ISA), which are designed to repay the loan principal on maturity. The following factors should be noted:

- Repayment mortgages incur no default probability adjustment.
- Interest-only mortgages are susceptible to the payment shock associated with a 'balloon' repayment for the entire principal at maturity. The borrower may be able to remortgage and thereby pay off his existing mortgage; however if his circumstances have changed this may not be possible. The further off the maturity date is, the more capacity there is for the borrower's circumstances to change. For this reason, Fitch applies an increased default factor to interest only loans of between 1 and 1.33 depending upon the length of time to maturity.

Loan Purpose

Fitch does not penalise mortgage loans advanced to purchase a home or those advanced to refinance existing mortgage loans, nor loans to release equity for the purpose of home improvements. However, Fitch views mortgage loans advanced to release equity in the home (equity refinance mortgages) in order to consolidate other existing debts (such as credit cards) as more risky by their nature. For this reason, Fitch applies an increased default factor of 1.1-1.25 depending on underwriting criteria for such loans.

Mortgages in Arrears

When rating a portfolio combining current and arrears mortgages, Fitch increases base default rates for mortgages in arrears up to 90 days by factors of between 1.25 and 1.75. For mortgages that are in arrears for more than 90 days, Fitch assumes a 100% default probability.

Second Homes

While information about mortgage performance for second homes is limited, Fitch believes that second homes are considerably more susceptible to default. A financially distressed borrower is more likely to default on a second home than on his primary residence. Accordingly, Fitch increases base default by a factor of 1.1-1.25.

Right to Buy

Council tenants have the opportunity to purchase their own homes through the UK government's Right to Buy scheme. Available information suggests that there is a higher propensity to default. For this reason Fitch applies and increases default probability factor of between 1.1 and 1.25.

Product Type

Most UK RMBS issues are primarily backed by variable-rate mortgages. While variable-rate mortgages can experience payment shock due to underlying index volatility, this risk is usually gradual with 0.5%-1% interest rate rises. Other mortgage types commonly available include initially fixed-rate mortgages and capped-rate mortgages which reset to variable rate after a limited period. Although these loans may be more susceptible to payment shocks after the reset date (if rates have risen substantially during the fixed- or capped-rate period), Fitch believes that this does not warrant a supplementary default factor. Other product types will be evaluated individually.

Loss Severity

Fitch's UK default model quantifies loss severity (or, conversely, recovery value) by focusing on several factors, including market value declines, foreclosure and carrying costs, and LTV.

Market Value Declines

Fitch's MVD methodology focuses on three key factors: volatility of observed prices from the long-term trend; historical levels of stress experienced in the housing market of each region; and the current position of the index relative to the long-term trend.

For example, the MVDs for East Anglia, London and the South East are highest, reflecting high historical volatility and current prices well above the long-term trend line. The MVD for Scotland is lowest, reflecting low historical volatility and current prices slightly below the long-term trend line.

Indexing of Property Valuation

Fitch's model uses a conservative index to adjust original property values depending on the year of valuation. The index is based on information obtained from sources in the mortgage industry and considers both the year of valuation and the region in which the property is located. Where there has been capital appreciation, this is a mitigating factor in the calculation of loss severity, but will be offset by higher MVDs assigned to regions that have seen above-average price appreciation.

High- and Low-Value Properties

Homes with relatively high or relatively low market values are generally subject to higher MVDs in a deteriorating market than homes with average market values, due to the limited demand for such properties. Imprecise pricing information, caused by the lack of comparable benchmark homes in the case of high-value properties, also influences the amount of price volatility during a market downturn. The market value thresholds are increased periodically to reflect the increase in housing prices. Adjustments for high- and low-value properties are split between London and the rest of the country due to higher prices in London, and the differential between what would constitute a high- or low-value property.

Mortgage Indemnity Guarantee (MIG) Policies

Many lenders require borrowers to pay for MIG for that portion of their mortgage loan which exceeds a certain LTV level (usually 75%). In case of default by the borrower, the lender will be able to recover any loss on the portion of the loan in excess of that LTV limit (subject to any policy deductions) from the MIG provider. Fitch will give credit for MIG on a case-by-case basis. Fitch will review the MIG policies to determine the extent of coverage and payment terms and to determine whether there are any exclusion clauses which might lead to non-payment of claims by the insurer. The insurer's rating is also taken into consideration when determining the amount of credit to be given for MIG.

Geographic Concentration

Fitch also assumes that a mortgage portfolio is generally broadly diversified in geographical terms. A particular region might be more sensitive to economic downturns and/or other negative developments in the property and mortgages market than others. If a portfolio has significant regional concentrations, Fitch will make adjustments on a case-by-case basis. As a general rule, for pools with high concentrations in specific regions, credit enhancement necessary for a particular rating level will be higher than for geographically diversified portfolios.

Foreclosure and Carrying Costs

When calculating recovery value, Fitch's model reduces the property valuation by foreclosure costs and the cost to the administrator of "carrying" the loan from delinquency through to default. Fitch assumes that foreclosure costs amount to 5% of the sale price at the time of foreclosure. This estimate is based on actual cost data supplied to Fitch, and may be adjusted as cost structures change in the industry and jurisdiction.

To calculate carrying costs, Fitch assumes that the borrower does not pay interest for 18 months in the case of a residential property and 12 months in the case of an investment property. The interest rate used reflects the need to continue to service the notes during the period that the defaulted loans are not generating any revenue. The 18- and 12-month time frames are based on worst-case estimates obtained from UK mortgage lenders.

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