

**Rating Action: Moody's confirms ratings in eight Paragon transactions on restructuring**

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Global Credit Research - 21 Feb 2013

**Fourteen notes in another four transactions downgraded on exclusion from restructuring**

London, 21 February 2013 -- Moody's Investors Service has today confirmed the Aaa(sf) ratings of the senior notes in eight Paragon Mortgages transactions following the execution of restructuring proposals. At the same time, Moody's downgraded the ratings of 10 senior and 4 junior notes in another four Paragon transactions excluded from the restructuring process. This rating action concludes the review for downgrade initiated by Moody's on 14 October 2011, following the downgrade of Skipton Building Society to Ba1/NP from Baa1/P-2. Moody's also announced on 29 March 2012 that it maintained the ratings on review due to the potential legal risks of exposure to pension liabilities of the Paragon Group. All affected ratings are listed towards the end of this press release.

**RATINGS RATIONALE**

Today's rating action follows the restructuring, or lack thereof, of the transactions and is mainly driven by the assessment of their exposure to (1) payment disruption risk; and (2) the pension liabilities of the Paragon Group (NR).

**-- CONFIRMATIONS REFLECT MITIGATION OF PAYMENT DISRUPTION RISK & PENSION LIABILITY EXPOSURE**

Moody's has confirmed its Aaa(sf) rating on the senior notes in eight transactions (i.e., Paragon Mortgages No.7 to No.13 & Paragon Mortgages No.15) because the structural features introduced during the restructuring have sufficiently mitigated both payment disruption risk and exposure to the pension liabilities of the Paragon Group.

These eight transactions are performing in line with expectations and Moody's has maintained its lifetime loss assumptions.

**-- PAYMENT DISRUPTION RISK**

Prior to restructuring, the back-up servicing and cash management arrangements were not commensurate with a Aaa(sf) rating. Homeloan Management Limited (HML), which is part of Skipton Building Society (Ba1/NP), acts as servicer, back-up servicer and back-up cash manager in all the Paragon transactions. The main servicers and cash managers in the affected transitions are members of the Paragon Group (NR). Despite "warm" back-up arrangements, the absence of a party with an investment grade sponsor weakens the efficiency of the back-up arrangements in mitigating payment disruption risk.

The restructuring has mitigated payment disruption risk by adding a back-up servicer facilitator (Structured Finance Management Limited) and estimation language. Structured Finance Management would assist the issuer in appointing a replacement cash manager or a replacement servicer in the event that HML (1) either became the primary servicer or the primary cash manager; or (2) fails to assume its responsibilities as per the back-up agreement. Administration servicers have been split into cash management and servicing to allow for separate transfers if needed. To ensure payment continuity over the transfer period the terms and conditions of the notes contain estimation language whereby the cash manager will estimate the cash flows from the three most recent servicer reports should a current servicer report not be available.

**-- EXPOSURE TO PARAGON GROUP'S PENSION LIABILITIES**

The issuers in the Paragon transactions may face a claim from the pensions regulator should (1) Paragon Group become insolvent and (2) its defined benefit occupational pension scheme not be fully funded. The issuers are part of the Paragon Group, which qualifies them as connected or associated entities. The pension regulator would not have access to the assets of the issuers outside of insolvency proceedings. However, if it were to institute insolvency proceedings against the issuers, the pensions regulator could recover a maximum of GBP600,000 from each issuer out of floating charge realisations and ahead of secured creditors. It would also be entitled to

claim as an unsecured creditor, amounts remaining (if any) after all secured creditors had been paid in full. Insolvency of the issuers would have potentially negative consequences for the Paragon transactions, the most significant of which would be the possible termination of cross-currency swap agreements.

The restructuring has mitigated the risk by enabling an out-of-court settlement with the pension regulator that should prevent it from petitioning for insolvency of the issuers. In particular, (1) the amended terms and conditions of the notes enable the issuers to enter into settlements with an unsecured claimant without prior approval of the trustee; (2) the amended and restated administration agreement requires the administrator to negotiate and conclude such settlement payments of up to GBP600,000 on behalf of each issuer, this requirement is binding on HML should it step in as a primary servicer; and (3) the payment under such a settlement is included into the priority of payments prior to enforcement.

#### -- DOWNGRADES REFLECT CONTINUED EXPOSURE TO PAYMENT DISRUPTION & PENSION CLAIM RISKS

Moody's downgraded the senior notes in three un-restructured transactions with substantial credit enhancement (i.e., First Flexible No.5 to No. 6 & Paragon Personal and Auto Finance) to Aa1(sf) due to continued exposure to payment disruption and pension claim risks in combination with limited severity of losses. In Moody's view, the structural features available in these transactions do not sufficiently mitigate the chance of payment disruption risk or the pension claims occurring. However, the available credit enhancement mitigates the severity of possible losses. For instance, the credit enhancement under the senior notes in First Flexible No.6 is 46% and in Paragon Personal and Auto Finance is 83% while the maximum loss from a cross currency swap termination is limited to 32% and 54%, respectively, which is a share of notes denominated in another currency. All notes in First Flexible No. 5 are denominated in British pounds, therefore the transaction would suffer no loss due to FX risk if the swaps are terminated.

At the same time, Moody's downgraded the Class A notes to Aa3(sf), Class B notes to A1(sf) and Class C notes to A3(sf) in one un-restructured transaction without substantial credit enhancement (i.e., Paragon Mortgages No. 14) in consideration of its continued exposure to the payment disruption and legal risks in combination with high severity of losses. In Moody's view, the structural features of Paragon Mortgages No. 14 may lead to substantial losses for noteholders should the payment disruption or pension claim risks materialise. In particular, 86% of the notes are denominated in currencies different from the underlying assets, while the credit enhancement under the senior notes is substantially lower than the currency exposure at 23%. Termination of the cross-currency swap, should it not be replaced, would expose Paragon Mortgages No.14 to substantial currency rate volatility.

The downgrade is not driven by the review of lifetime loss assumptions as the performance of the underlying mortgage portfolios to date has been in line with Moody's expectations.

#### FACTORS AND SENSITIVITY ANALYSIS

Moody's has not updated key modelling assumptions, sensitivities, cash-flow analysis and stress scenarios, as the rating action has been primarily driven by a review of operational and legal risks. Uncertainty mainly stems from the timing of a servicing transfer, the availability of replacement parties, the likelihood of the pension regulator making a claim and the timeliness of the out-of-court settlement. The rating would be negatively affected, should a servicing transfer take longer than expected following (1) an operational disruption, (2) the inability to find replacement parties in a timely fashion, or (3) the lack of a settlement with the pension regulator.

As the euro area crisis continues, the ratings of structured finance notes remain exposed to the uncertainties of credit conditions in the general economy. The deteriorating creditworthiness of euro area sovereigns as well as the weakening credit profile of the global banking sector could negatively affect the ratings of the notes.

The principal methodology used in rating Paragon Personal and Auto Finance (No. 3) plc was Moody's Approach to Rating Consumer Loan ABS Transactions published in October 2012.

The principal methodology used in rating First Flexible No. 5 plc, First Flexible No. 6 plc, Paragon Mortgages (No. 7) PLC, Paragon Mortgages (No. 8) PLC, Paragon Mortgages (No. 9) PLC, Paragon Mortgages (No. 10) PLC, Paragon Mortgages (No. 11) PLC, Paragon Mortgages (No. 12) PLC, Paragon Mortgages (No. 13) PLC, Paragon Mortgages (No. 14) PLC and Paragon Mortgages (No. 15) PLC was Moody's Approach to Rating RMBS in Europe, Middle East, and Africa published in June 2012. Please see the Credit Policy page on [www.moody.com](http://www.moody.com) for a copy of these methodologies.

Other factors used in these ratings are described in Global Structured Finance Operational Risk Guidelines: Moody's Approach to Analyzing Performance Disruption Risk published in June 2011.

## LIST OF AFFECTED RATINGS

Issuer: First Flexible No. 5 plc

....GBP465MA Notes, Downgraded to Aa1 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: First Flexible No.6 plc

....GBP270MA1 Notes, Downgraded to Aa1 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR200MA2 Notes, Downgraded to Aa1 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....US\$75MA3 Notes, Downgraded to Aa1 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Mortgages (No. 7) PLC

....US\$450MA1a Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....GBP220MA1b Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR500MA1c Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Mortgages (No.8) PLC

....GBP305MA2a Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR453MA2b Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Mortgages (No. 9) PLC

....GBP346MAa Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR355MAb Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....US\$60MAc Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Mortgages (No. 10) PLC

....US\$1100MA1 Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....GBP105MA2a Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR222MA2b Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Mortgages (No. 11) PLC

....US\$985MA1 Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....GBP149.5MA2a Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for

#### Possible Downgrade

....EUR219.7MA2b Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Mortgages (No. 12) PLC

....US\$1500MA1 Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....GBP145MA2a Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR245MA2b Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....US\$311MA2c Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Mortgages (No. 13) PLC

....US\$1500MA1 Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....GBP125MA2a Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR315MA2b Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....US\$350MA2c Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Mortgages (No.14) PLC

....US\$1500MA1 Notes, Downgraded to Aa3 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....GBP125MA2a Notes, Downgraded to Aa3 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR246MA2b Notes, Downgraded to Aa3 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....US\$400MA2c Notes, Downgraded to Aa3 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....GBP51.9M B1a Notes, Downgraded to A1 (sf); previously on Mar 22, 2007 Definitive Rating Assigned Aa2 (sf)

....EUR88.8M B1b Notes, Downgraded to A1 (sf); previously on Mar 22, 2007 Assigned Aa2 (sf)

....GBP20M C1a Notes, Downgraded to A3 (sf); previously on Mar 22, 2007 Definitive Rating Assigned A2 (sf)

....EUR135.5M C1b Notes, Downgraded to A3 (sf); previously on Mar 22, 2007 Assigned A2 (sf)

Issuer: Paragon Mortgages (No.15) PLC

....US\$1000MA1 Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....GBP209.5MA2a Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

....EUR110MA2b Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

...US\$150MA2c Notes, Confirmed at Aaa (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

Issuer: Paragon Personal and Auto Finance (No. 3) plc

...GBP146MA1 Notes, Downgraded to Aa1 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

...EUR259.5MA2 Notes, Downgraded to Aa1 (sf); previously on Oct 14, 2011 Aaa (sf) Placed Under Review for Possible Downgrade

#### REGULATORY DISCLOSURES

Moody's did not receive or take into account a third-party assessment on the due diligence performed regarding the underlying assets or financial instruments related to the monitoring of these transactions in the past six months.

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