FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Paragon Mortgages (No. 25) and Paragon Mortgages (No. 26)

Mon 12 Oct, 2020 - 12:51 PM ET

Fitch Ratings - London - 12 Oct 2020: Fitch Ratings has affirmed Paragon Mortgages (No. 25) PLC (Paragon 25) and Paragon Mortgages (No. 26) PLC (Paragon 26) and removed Paragon 26's class C and D notes from Rating Watch Negative (RWN), as detailed below.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Paragon Mortgages (No.25) PLC				
• A XS1785818649	LT	AAAsf Rating Outlook Stable	Affirmed	AAAsf Rating Outlook Stable
• B XS1785821437	LT	AAsf Rating Outlook Stable	Affirmed	AAsf Rating Outlook Stable

ENTITY/DEBT	RATING			PRIOR
• C XS1785821940	LT	A-sf Rating Outlook Stable	Affirmed	A-sf Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

TRANSACTION SUMMARY

The transactions are the 25th and 26th from the Paragon series consisting of buy-to-let (BTL) mortgages originated by Paragon Mortgages (2010) Limited, Paragon Bank plc and other members of the Paragon Banking Group.

KEY RATING DRIVERS

Off RWN

Paragon 26's class C and D notes have been removed from RWN. They were placed there in April in response to the coronavirus outbreak (see Fitch Places 140 UK RMBS Ratings on RWN on Coronavirus Pandemic at www.fitchratings.com).

The RWN reflected our expectation of weakening asset performance. We have analysed the transactions under our coronavirus assumptions (see EMEA RMBS: Criteria Assumptions Updated due to Impact of the Coronavirus Pandemic at www.fitchratings.com) and considered the ratings sufficiently robust to be affirmed.

Coronavirus-related Additional Assumptions

We expect a generalised weakening in borrowers' ability to keep up with mortgage payments due to the economic impact of the coronavirus pandemic and the related containment measures. As a result, Fitch applied coronavirus assumptions to the mortgage portfolio.

The combined application of revised 'Bsf' representative pool weighted average foreclosure frequency (WAFF), revised rating multiples and arrears adjustment resulted in a multiple to the current FF assumptions in a range of 1.21x to 1.36x at 'Bsf' and of 1.01x to 1.06x at 'AAAsf' in each transaction. The coronavirus assumptions are more modest for higher rating levels as the corresponding rating assumptions are already meant to withstand more severe shocks.

Borrowers on payment holiday in Paragon 25 and 26 represented 5.6% and 6.4%% of the portfolio balances, respectively, as of end of August 2020. Payment holidays in Paragon transactions are decreasing in line with the trend observed in peer transactions. Fitch does not view payment holidays as a liquidity risk in these transactions and has not applied additional stresses in relation to payment holidays.

Stable Asset Performance to Date

Asset performance has remained strong, with arrears by more than one monthly payment at 0.25% (Paragon 25) and 0.11% (Paragon 26) as of July 2020. Given the BTL nature of the underlying pool, borrowers in arrears by more than two months are predominantly managed by Paragon via its receiver of rent policy, where the full rental stream is diverted to Paragon, as administrator, and used towards clearing arrears. Paragon's extensive use of its receiver of rent policy has therefore contributed towards the low level of delinquencies across the series. Prepayments for both transactions have not peaked at as high levels as previous Paragon transactions, as the pools are still mostly on a fixed rate.

Despite the stable performance to date Fitch expects deterioration in asset performance, as described above, and applied coronavirus assumptions to the mortgage portfolio including an adjustment to the arrears in the pools.

Product Switches

While the switches in the repayment types are limited, before the step-up date there are only minor limitations on the potential switches regarding any interest rate conversions. Fitch has therefore modelled extensive use of the interest rate conversions to stress any excess spread in the asset portfolio and hedging interest rate mismatches.

Revolving Transaction

Paragon 25 features a five-year revolving period, of which more than two years have elapsed, which allows new assets to be added to the portfolio. While the replenishment criteria mitigate risks about the potential migration of the portfolio's credit profile, there remains the risk of some deterioration during the revolving period. Fitch assumed changes to the portfolio characteristics, giving credit to the replenishment criteria listed in the transaction documentation where relevant.

Class A Scheduled Amortisation

After the first year of fully revolving period, credit enhancement has started to build up in line with the scheduled amortisation from August 2019. Principal on Paragon 25's class A notes will be paid according to a target scheduled amortisation until the end of the revolving period in May 2023, while the remaining principal amounts (if any) can be used by the issuer to purchase new assets.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/ downgrade:

The broader global economy remains under stress due to the coronavirus pandemic, with surging unemployment and pressure on businesses stemming from social-distancing guidelines. Recent government measures related to the coronavirus pandemic introduced a suspension on tenant evictions for three months and mortgage payment holidays, also for up to six months. Fitch acknowledges the uncertainty of the path of coronavirus-related containment measures and has therefore considered more severe economic scenarios.

As outlined in "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases", Fitch considers a more severe downside coronavirus scenario for sensitivity purposes whereby a more severe and prolonged period of stress is assumed with a halting recovery from 2Q21. Under this scenario, Fitch assumed a 15% increase in WAFF and a 15% decrease in WARR. The results indicate an adverse rating impact of up to two notches in PM25 and up to three notches in PM26.

The transactions' performance may be affected by changes in market conditions and economic environment. Weakening asset performance is strongly correlated to increasing levels of delinquencies and defaults that could reduce credit enhancement (CE) available to the notes.

Additionally, unanticipated declines in recoveries could also result in lower net proceeds, which may make certain note ratings susceptible to potential negative rating actions depending on the extent of the decline in recoveries. Fitch conducts sensitivity analyses by stressing both a transaction's base-case FF and RR assumptions, and examining the rating implications on all classes of issued notes.

Factors that could, individually or collectively, lead to rating positive action/ upgrade:

Stable to improved asset performance driven by stable delinquencies and defaults would lead to increasing CE levels and potential upgrades. Fitch tested an additional rating sensitivity scenario by applying a decrease in the FF of 15% and an increase in the RR of 15%. The ratings on the subordinated notes could be upgraded by up to two notches in PM25 and up to one notch in PM26.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Structured Finance transactions have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of seven notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of seven notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAAsf' to 'Dsf'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CRITERIA VARIATION

For the Paragon 25 transaction Fitch applied the following variation to its published criteria.

Fitch varied the constant prepayment rate assumptions, as outlined in Fitch's UK RMBS Rating Criteria, for the remaining years of the envisaged revolving period to match the target scheduled amortisation of the class A notes during the revolving period and address potential over-hedge. The application of the variation have a rating impact of two notches on the class B, C and D notes.

USE OF THIRD PARTY DUE DILIGENCE PURSUANT TO SEC RULE 17G -10

Form ABS Due Diligence-15E was not provided to, or reviewed by, Fitch in relation to this rating action.

DATA ADEQUACY

Fitch has checked the consistency and plausibility of the information it has received about the performance of the asset pools and the transactions. There were no findings that affected the rating analysis. Fitch has not reviewed the results of any third-party assessment of the asset portfolio information or conducted a review of origination files as part of its ongoing monitoring.

Prior to the transactions' closing, Fitch reviewed the results of a third-party assessment conducted on the asset portfolio information and concluded that there were no findings that affected the rating analysis. Prior to the transactions' closing, Fitch conducted a review of a small targeted sample of Paragon's origination files and found the information contained in the reviewed files to be adequately consistent with the originator's policies and practices and the other information provided to the agency about the asset portfolios.

Overall and together with the assumptions referred to above, Fitch's assessment of the information relied upon for the agency's rating analysis according to its applicable rating methodologies indicates that it is adequately reliable.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on Paragon 25 and Paragon 26, either due to their nature or the way in which they are being managed. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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APPLICABLE CRITERIA

Fitch Ratings Interest Rate Stress Assumptions for Structured Finance and Covered Bonds (Excel) (pub. 06 Dec 2019)

Structured Finance and Covered Bonds Interest Rate Stresses Rating Criteria (pub. 06 Dec 2019)

Structured Finance and Covered Bonds Counterparty Rating Criteria (pub. 29 Jan 2020)

Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum (pub. 29 Jan 2020)

Global Structured Finance Rating Criteria (pub. 17 Jun 2020) (including rating assumption sensitivity)

UK RMBS Rating Criteria (pub. 02 Jul 2020) (including rating assumption sensitivity)

Structured Finance and Covered Bonds Country Risk Rating Criteria (pub. 23 Sep 2020)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Multi-Asset Cash Flow Model, v2.9.0 (1)

ResiGlobal Model: UK, v1.2.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Paragon Mortgages (No.25) PLC	EU Issued
Paragon Mortgages (No.26) PLC	EU Issued

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Structured Finance   Structured Finance: RMBS   Europe   United Kingdom

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