Paragon Mortgages (No.20) plc

Presale

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Paragon Mortgages (No.20) PLC

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Capital Structure

Class	Rating	Outlook	Amount (GBPm)	CE[c] (%)	Final maturity	TT[a] (%)	TTLM[b]
A	AAAsf	Stable	TBD	8.81	Nov [2041]	91.25	110.3
B	AA−sf	Stable	TBD	2.06	Nov [2041]	6.75	8.2
D	NRsf	Stable	TBD	n.a.	Nov [2041]	2.00	2.4
Total issuance			**TBD**				

Expected ratings do not reflect final ratings and are based on information provided by the issuer as of 27 June 2014. These expected ratings are contingent on final documents conforming to information already received
[a] Tranche thickness percentage - ratio of class size to collateral balance
[b] Tranche thickness loss multiple - TT% divided by Fitch's base case loss expectation. See also *Structured Finance Tranche Thickness Metrics*, 29 July 2011
[c] Credit enhancement – The actual credit enhancement could be different from that modelled and the final capital structure will be assessed before assigning final ratings

Transaction Summary

Fitch Ratings has assigned expected ratings to the residential mortgage-backed notes to be issued by Paragon Mortgages (No.20) PLC (PM20), an SPV incorporated in England and Wales. Fitch expects the final pool of loans backing the notes at the end of the pre-funding period to consist of 98.9% UK prime buy-to-let (BTL) residential mortgages originated by Paragon Mortgages (2010) Limited (Paragon) and 1.1% BTL mortgages acquired by Idem Capital Securities Limited (Idem).

Paragon and Idem (together, the sellers) are wholly owned by Paragon Group plc. At close, the issuer will purchase 81.4% of the expected final pool, with the remaining 18.6% expected to be acquired during the three month pre-funding period. Of the loans, 32.4% are currently in the Paragon Mortgages (No. 16) PLC (PM16) transaction and Fitch expects them to be called on the closing date of and sold to PM20 transaction. The loans are to be serviced by Paragon Finance plc, with Homeloan Management Limited (HML) acting as back-up servicer.

Key Rating Drivers

Fully Buy-to-Let Portfolio: The portfolio consists entirely of BTL loans and Fitch continues to stress the portfolio's default rates beyond those of a prime owner-occupier portfolio at all rating levels, despite the historically lower arrears of past Paragon deals. A higher default probability was assumed for Idem loans as they were acquired from a specialist originator and originated at the peak of the market (2007).

High Prepayments Modelled: PM16 has had a high conditional prepayment rate (CPR), above Fitch's typical high CPR stress. PM16 loans feature a mandatory switch from interest-only to repayment after a specified period. This provides an incentive for the borrower to refinance. The high CPR scenario is the most stressful, and is therefore a key rating driver. Fitch has modelled the transaction to withstand a 30% CPR stress for the first two years.

Paragon Transactions Performing Well: RMBS transactions with loans originated by Paragon have historically performed strongly, with low arrears and defaults. Fitch considers the good performance favourably, and has factored this into its analysis (see *Performance Analytics* below for further details).

Unrated Originator and Sellers: The originator and sellers are not rated entities and as such may have limited resources available to repurchase any mortgages in the event of a breach of Reps and Warranties (RW) given to the Issuer. Whilst Fitch considers this a weakness, there are a number of mitigating factors that make the likelihood of a RW breach remote (see Page 4).

Key Parties

Issuer: Paragon Mortgages (No.20) plc

Originator: Paragon Mortgages (2010) Limited (PML) and Undisclosed (Idem)

Seller: Paragon Mortgages (2010) Limited and Idem Capital Securities Limited

Servicer: Paragon Finance PLC

Back-up Servicer: Homeloan Management Limited (RPS1−)

Administrators: Paragon Mortgages (2010) Limited and Paragon Finance PLC

Trustee: Citicorp Trustee Company Limited

Subordinated Lender: Paragon Finance PLC

Transaction Account Bank: Barclays Bank plc (A/Stable/F1)

Collection Accounts: Barclays Bank plc and National Westminster Bank plc (A/Negative/F1)

Principal Paying Agent: Citibank, N.A., London Branch (A/Stable/F1)

Swap Providers: Macquarie Bank Limited (A/Stable/F1) and Lloyds Bank plc (A/Negative/F1)

Arrangers: Lloyds Bank plc and Macquarie Bank Limited, London Branch

Joint Lead Managers: Lloyds Bank plc, Macquarie Bank Limited, London Branch and Morgan Stanley & Co. International plc

Related Criteria

EMEA Residential Mortgage Loss Criteria (May 2014)

Criteria Addendum: UK Residential Mortgage Loss and Cash Flow Assumptions (May 2014)

EMEA RMBS Master Rating Criteria (May 2014)

EMEA RMBS Cash Flow Analysis Criteria (May 2014)

Counterparty Criteria for Structured Finance and Covered Bonds (May 2014)

Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum (May 2014)

Criteria for Servicing Continuity Risk in Structured Finance (July 2013)

Representations, Warranties, and Enforcement Mechanisms in Global Structured Finance Transactions (April 2012)

Structured Finance Tranche Thickness Metrics (July 2011)

Rating Sensitivity[1]

This section of the report provides an insight into the model-implied rating sensitivities to hypothetical changes in defaults and/or recoveries on the assets in a stressed environment. These increased defaults and/or recoveries on assets are relative to the dynamic weighted average frequency of foreclosure (WAFF) of the mortgage portfolio (20.98% for the 'AAAsf' rating scenario) and the dynamic weighted average recovery rate (WARR) of the mortgage pool (49.20% for the 'AAAsf' rating scenario), respectively; they are assumed to occur immediately after closing of the transaction. The model-implied rating sensitivities, based on such assumptions, are only indicative of some of the potential outcomes and do not consider other risk factors to which the transaction is exposed.

Rating Sensitivity to Defaults

	Class A	Class B
Original rating	AAAsf	AA-sf
15% increase in default rates	AA+sf	A+sf
30% increase in default rates	AA+sf	A+sf

Source: Fitch

Rating Sensitivity to Recovery Rates

	Class A	Class B
Original rating	AAAsf	AA−sf
15% decrease in recovery rates	AA+sf	A+sf
30% decrease in recovery rates	AA+sf	A+sf

Source: Fitch

Rating Sensitivity to Shifts in Multiple Factors

	Class A	Class B
Original rating	AAAsf	AA−sf
15% increase in default rates, 15% decrease in recovery rates	AA+sf	A+sf
30% increase in default rates, 30% decrease in recovery rates	AA−sf	A−sf

Source: Fitch

Model, Criteria Application and Data Adequacy

Fitch analyses the collateral for UK residential transactions using a country-specific, loan-by-loan mortgage default model. The model subjects the mortgage loans to stresses based on Fitch's assessment of historical house price movements and mortgage defaults in the UK. The agency's study showed that a borrower's loan-to-value ratio (LTV), reflecting the size of their down-payment and their willingness to pay, and a borrower's debt-to-income (DTI) ratio or income multiple, reflecting their ability to pay, to be the key determinants of default probability in the UK.

Paragon provided Fitch with a loan-by-loan data template, cumulative loan book losses, and 90+ arrears data. Fitch considers that the data available for the analysis is of good quality.

The Idem loans were acquired from a specialist lender known to Fitch at the peak of the market (2007) and a higher default probability and higher ICR stress rate was applied based on this information.

An Agreed Upon Procedures report (AUP) from an internationally recognised auditing firm verifying data accuracy is expected to be provided to Fitch.

[1] These sensitivities only describe the model-implied impact of a change in the input variables. This is designed to provide information about the sensitivity of the rating to model assumptions. It should not be used as an indicator of possible future performance

The collateral review of the mortgage portfolio also involves reviewing loan-by-loan loss severity information on the originator's sold repossessions, during which the agency determines the originator's experienced loss severity rate and quick-sale adjustment (QSA). The QSA, calculated using the repossession data provided by the originators, was about 32% for the Paragon loans. As the QSA figures are higher than Fitch's criteria assumption of about 30%, Fitch has increased the assumptions for the QSA to 32% for the pool.

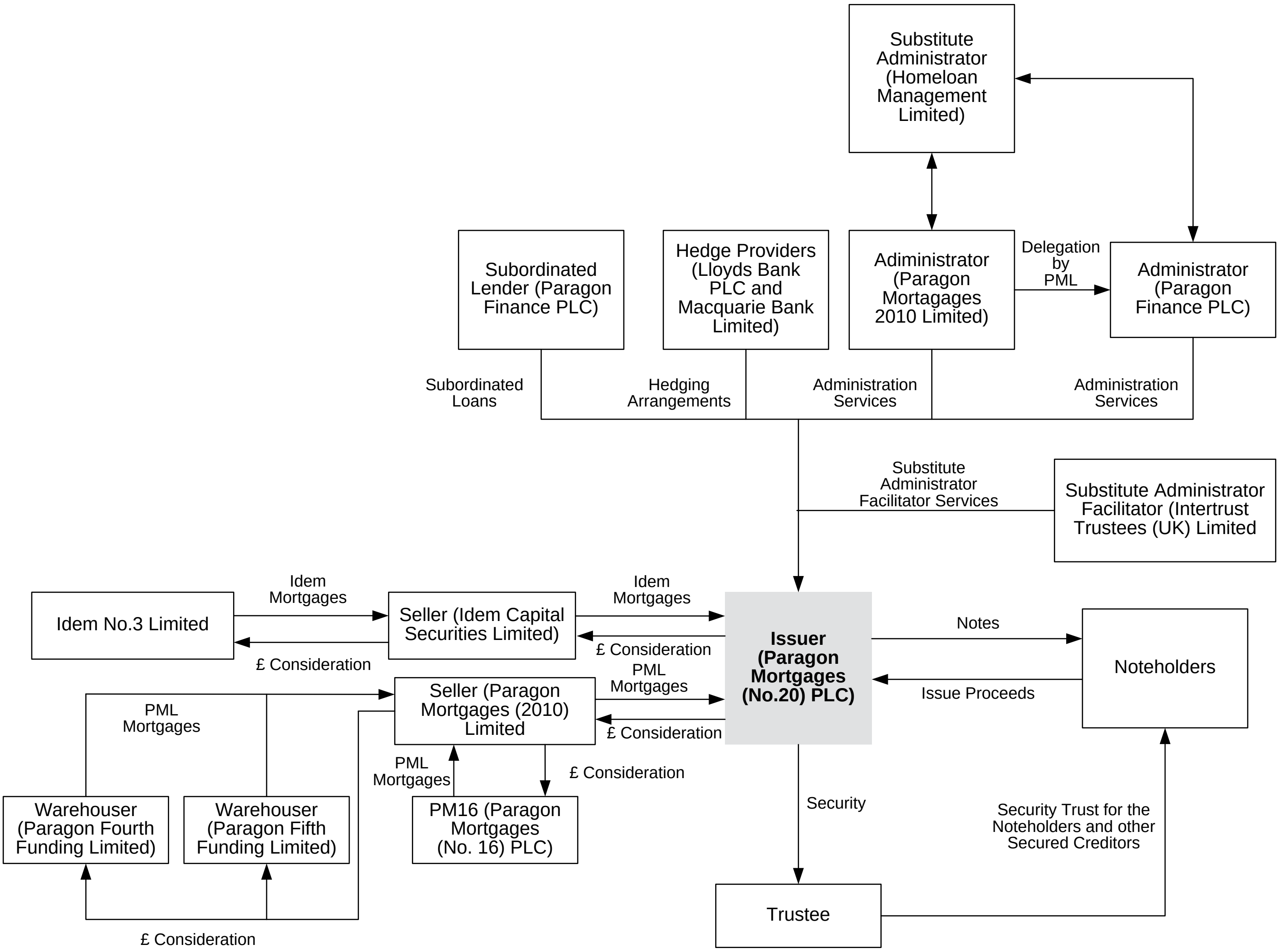
To determine the levels of credit enhancement needed to support the ratings, Fitch simulated the transaction's cash flows using a model incorporating its cash flow stresses.

Transaction and Legal Structure

Legal Framework

On or about the closing date, the sellers will assign the rights, title and interest in and to the mortgages to PM20 (a public company incorporated under the laws of England and Wales). There will be no recourse to the sellers (except regarding loans sold in breach of warranty) so that the transfer to PM20 is treated as a true sale.

Figure 1
Structure Diagram



Source: Transaction documents

At closing, PM20 will enter into a deed of charge, creating security over its assets in favour of the trustee as security for all payments under the notes. The security will include first-ranking sub-mortgages and first-ranking fixed charges in favour of the trustee over all the issuer's rights, claims, title, benefit and interest in and to the underlying collateral.

The transaction structure is designed to ensure that seller insolvency would not interrupt the timely payment of principal and interest on the notes to investors. The sellers will assign their rights, title and interest in and to the mortgages to the issuer. There will be no recourse to either Paragon or Idem as the sellers of the mortgages; the transfers are treated as a true sale.

The transaction has a pre-funding period in which Paragon may sell further loans to PM20, subject to certain conditions, including:

- A certificate of a director of Paragon confirms that the additional mortgages were originated in accordance with the Paragon Mortgages (2010) Limited lending guidelines.
- No enforcement notice has been served on the issuer.
- No event of default of the notes has occurred.
- The aggregate of the 20 largest borrowers' current balance does not exceed GBP30m.

Representations and Warranties

The sellers Paragon Mortgages (2010) Limited and Idem are standalone vehicles, and therefore have limited resources to repurchase any mortgage receivables that breach the R&Ws given to the issuer. Fitch conduct further checks on the quality of the originations and performance data to assess the risk of R&W breaches in RMBS backed by mortgage loans where the sellers and provider of R&Ws is rated below investment grade, not rated by Fitch, or an SPV with limited capital. These checks include the following:

Loan File Reviews

During the previous 12 month period on a site visit to Paragon's offices Fitch conducted an extended file review to check the quality of Paragon's originations on a larger number of loans (20 loans) than would typically be assessed during a review of an established prime lender. No material issues were found.

Pool Audit

Fitch will receive an agreed-upon procedures (AUP) report on a sample of the pool reviewed by an internationally recognised accounting firm before the transaction closes.

Historical Experience

Paragon has a long history of originating mortgage loans, dating back to the late 1990s, and was able to confirm that it has only suffered one breach to date despite selling or securitising the majority of its originations to date. Paragon gave full R&Ws on the loans in those transactions in line with that for this transaction.

The mortgage sale agreement contains representations and warranties (R&Ws) given by the sellers in relation to the pool of mortgages. No search of title has been conducted by the issuer or the trustee; rather they have relied on the R&Ws. If there is an irremediable breach of any of the R&Ws, the seller will be required to repurchase the loan(s) in question.

Specifically, the representations and warranties include the following:

- Each mortgage is secured on a freehold or leasehold residential, or mixed commercial/residential property situated in England or Wales.
- No lien or right of set-off exists between the mortgagee and any borrower.
- No mortgage is or will be repayable later than 31 October 2039.
- No obligation to make a further advance if a borrower is in breach of mortgage conditions.
- At the relevant purchase date, the maximum aggregate principal amount of all arrears on mortgages that may be purchased by the issuer is GBP1m.

Further Advances

Discretionary 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, among others:

- there was no debit balance on the principal deficiency ledger (PDL) as at the previous interest payment date;
- the reserve fund is at its required amount;
- the WA current LTV of the portfolio would not increase in value by more than 1% after utilising the pre-funding;
- arrears over three months do not exceed 2% of the then-outstanding balance of the pool;
- the aggregate current balance of the 20 largest borrowers does not exceed GBP30m,;
- minimum interest rate for discretionary further advances is three-month sterling Libor or Bank of England Base Rate (as applicable), plus 4.50%.

Discretionary further advances are capped at 8% of the initial note balance.

Disclaimer

For the avoidance of doubt, Fitch relies, in its credit analysis, on legal and/or tax opinions provided by transaction counsel. As Fitch has always made clear, Fitch does not provide legal and/or tax advice or confirm that the legal and/or tax opinions or any other transaction documents or any transaction structures are sufficient for any purpose. The disclaimer at the foot of this report makes it clear that this report does not constitute legal, tax and/or structuring advice from Fitch, and should not be used or interpreted as legal, tax and/or structuring advice from Fitch. Should readers of this report need legal, tax and/or structuring advice, they are urged to contact relevant advisers in the relevant jurisdictions.

Asset Analysis

Lender Adjustment

Fitch's base default probabilities assume that origination, underwriting and servicing practices and procedures are in line with those of a standard traditional UK mortgage lender with market expertise, financial stability and relevant management experience.

As part of the analysis, the agency performs an operational review of the originator to assess the origination, underwriting and servicing capabilities of the seller. As a result of this review, if Fitch believes that origination, underwriting and servicing procedures are below market standards, an adjustment to the base default probabilities of the whole portfolio is warranted. The relevance of this adjustment is further sized by considering certain elements that cannot be factored into the analysis on a loan-by-loan basis, either because they are not available or because they are only applicable on an aggregate basis.

As a mortgage company, Paragon specialises in the origination of BTL products through intermediaries, and since February 2001 the vast majority of originations have been to professional BTL investors. To qualify for the benefits of such a loan a borrower must already possess a portfolio of at least three properties and must present a minimum of two years financial accounts for the underwriters to scrutinise. Such professional BTL investors 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.

For new originations, the rental income from single, self-contained properties must be a minimum of 125% of the mortgage payment calculated on an interest only basis, at either the product rate, or a reference rate of 5%, whichever is the higher. The rental income for all other property types must be a minimum rental income of 130% of the mortgage payment calculated on an interest only basis, at either the product rate, or the reference rate of 7%, whichever is the higher.

Fitch has considered several strengths and concerns in its lender adjustment (see also *Appendix B - Origination, Underwriting and Servicing*).

Among others, the main concerns are as follows: (1) Paragon is a niche market lender and this market has decreased over the last several years. Demand for such products could result in an acceptance of lesser quality loans or applications being agreed or received, however this can be mitigated by the low arrears levels evidenced; (2) only intermediary business is accepted as Paragon does not have a high street presence, although this is mitigated by the quality and experience of intermediaries on the robustly controlled panel.

In Fitch's view, strengths to consider are: (1) Paragon has an excellent track record with very low levels of arrears and this is assisted by a thorough understanding and application of the receiver of rent policy; (2) affordability is stressed significantly over the current pay rate; (3) all mortgage applications require a full valuation.

The Idem loans were acquired from a specialist lender, known to Fitch, at the peak of the market (2007) and a higher default probability as well as a higher ICR stress rate was applied based on this information. These loans are performing with no history of adverse credit prior to origination and underwent full revaluations in 2014; all the loans had an LTV less than 85%.

It is also important to note that, given the current state of the mortgage market, it is difficult for buyers to secure mortgages due to tighter lending criteria and limited product availability. This has, and quite possibly will for the foreseeable future, cause borrowers to remain in their current rental agreement(s) thus increasing the demand for rental properties and leading to an increase in rents by landlords. This will, and has, caused an increase in revenues for professional landlords and reduced the arrears rates in BTL securitisations. Potential interest rate rises will be the biggest single risk factor.

Buy-To-Let

Fitch expects 100.0% of the loans in the final pool at the first principal determination date to be prime BTL loans. Fitch considers loans on BTL properties to be inherently more susceptible to default than those secured on an owner-occupied property because:

- 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.

One important mitigating feature of BTL loans is that, upon default, the foreclosure process is quicker than for owner occupied properties, as tenants with short-hold tenancy agreements can generally be more easily evicted than owner-occupiers, while the repossession process through the courts is shorter.

In addition, Fitch has noted that a high proportion of the borrowers in this pool are professional landlords, with a minimum of 24 months' experience of managing at least three properties and with a recognised aptitude for enforcing tenancy contracts. The remaining BTL borrowers are private investor landlords, also with significant experience who aim to stay in the market long term.

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

For BTL properties a receiver of rent process (ROR) can be used to manage repossessed properties. Following the appointment, the ROR will directly collect rent from paying tenants and pass it to the lender to pay down any arrears. This helps maintain the rental income stream and would thus keep a steady flow of cash to the transaction.

Interest-Only Loans

Fitch expects 90.1% of the loans in the final pool to be interest only, which is typically the loan vehicle favoured by BTL borrowers.

Interest-only loans can be construed to be riskier than amortising loans because of the greater risk that the borrower may be unable to repay the debt in full at maturity (ie balloon payment risk). However, interest-only hits will ordinarily not apply to BTL products as the BTL market is almost entirely interest-only which is factored into the general BTL product adjustments. The risk in this transaction is further mitigated by the fact that the borrowers are predominantly professional landlords with a demonstrated ability to manage a property with an interest-only loan, and given the strong historic performance on previous Paragon transactions.

In light of the mitigants above no adjustment has been made to interest-only loans in this pool.

Concentration Risk

The small initial portfolio size at closing could potentially lead to two levels of concentration risk in this transaction.

The first emanates at the loan level where any single loan could potentially cause disproportionately larger losses than would be the case in a larger more diversified pool. The second relates to Paragon's business model of targeting professional landlords who typically have a number of BTL loans with Paragon. Hence if one landlord has a number of loans in the pool, each one not large in itself, the total exposure could become significant.

Fitch also considers the level of concentration in the transaction's mortgage portfolio to be a key factor in the assessment of tail risk within a particular transaction.

Receiver of Rent (ROR)

Fitch believes the risk of exposure to a single loan or borrower is mitigated to a large extent by Paragon's reliance on the ROR process. If Paragon believes a borrower is struggling it will appoint a ROR on the entire portfolio of the borrower, which does not require court approval. They will send a surveyor with a property agent to the property and inform the tenant that they have to send their rent to the ROR, who forwards it on to Paragon, instead of paying the landlord and no monies from that point onwards are allowed to be passed on to the borrower. Any payments received in excess of monthly mortgage payments are used to prepay the loans. Where the property is vacant a decision is made to rent or sell the property and a locksmith will also change the locks to the property.

This is a process Paragon initiates early on (typically within two months) as part of a pro-active approach to monitoring and managing arrears. Paragon holds discussions with borrowers, who have been identified as struggling to keep up with payments, regarding their current financial situation and then assess their ability to continue managing the property effectively.

Even if a borrower becomes current at a later date, Paragon is not obliged to release the property back to the borrower, which could effectively force a borrower to redeem all the mortgages with Paragon.

Self-Employed Borrowers

Fitch expects 53.8% of borrowers in this pool to be self-employed. These are typically professional landlords who rely solely on rental income for their earnings. Given the demonstrated ability of professional landlords to manage a property (based on the previous performance of Paragon transactions) no adjustment was made for borrowers designated as self-employed in this pool.

Illiquid Properties

Fitch expects 18.9% of the loans to fall into its jumbo and small categories, which represent property values at the less liquid ends of the property market.

Historical portfolio performance in most countries typically shows that high-value and low-value properties tend to realise higher than average relative losses, even in times of low stress in the housing market.

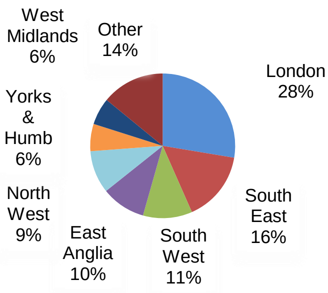
Where a property value is classified as high or low, Fitch will reduce the distressed property value after deduction of the MVD by an incremental illiquidity adjustment factor. These illiquidity adjustment factors are derived by rating scenario, with a larger haircut applied to the distressed property value (i.e. after indexation and MVD) in more stressed scenarios.

Quick Sale Adjustment

The Market Value Decline (MVD), which reflects Fitch's view of each region's vulnerability to house price declines, and reflects historical experience and socioeconomic factors, also incorporates a QSA. This is the discount a seller is likely to have to suffer for selling a property in a depressed market; often reflecting non-marketable conditions. Professional landlords also tend to modify properties in order to maximise rental yields which can affect the market value of the properties, or use additional revenue to undo the modifications, when it comes to a sale. The QSA is the same across all regions and rating scenarios.

The QSA, calculated using the repossession data provided by Paragon, was about 32% for Paragon. As the QSA figures were higher than Fitch's criteria assumptions, the agency has increased the assumptions for the QSA for PM20.

Figure 2
Property Location
Region



Source: Fitch

Geographical Concentration

The mortgage portfolio is skewed towards London and southeast England (see Figure 2). Fitch expects about 43.4% of the properties in the mortgage portfolio to be located in London and the southeast.

Although the percentage of loans in London and the southeast is marginally higher than the proportion of the UK population in these regions, Fitch did not consider the concentration to be analytically significant. It has therefore not made any adjustment to the default probability based on geographical concentration.

Default Model Output

The following table illustrates the asset analysis results across different rating scenarios. Fitch has used these WAFF and WARR levels when modelling the transaction cash flows.

Figure 3
Fitch Default Model Output (Dynamic Pool – Post Pre-Funding)

Rating level (%)	WAFF[a]	WARR[b]	MVD[c]
AAA	20.98	49.20	64.54
AA	16.97	54.69	60.72
A	12.62	60.17	56.90
BBB	8.55	65.63	53.08

Recovery time (years): Interest accrued on contractual rate for three years at 'AAA'
Recovery cost: 2.5% plus GBP3,000 fixed cost
[a] Weighted-average foreclosure frequency
[b] Weighted-average recovery rate
[c] Market value decline
Source: Fitch

Financial Structure and Cash Flow Modelling

Credit Enhancement

Subordination

The class B and D notes will be sized at 6.75% and 2.00% of the mortgage portfolio respectively, and will provide credit enhancement to the class A note. Any principal losses resulting from the mortgage portfolio will be recorded on the PDL which will be paid in such a way that the amount corresponding to the Class A notes will be paid first before the amount corresponding to the class B and D notes.

First Loss Fund

To provide limited coverage for any interest shortfalls and principal losses, the issuer will establish at closing, a non-amortising first loss fund to the amount of 3% of the initial total collateral balance. This can step up to 4% of the initial total collateral balance if 60+ days arrears exceed 3% of the outstanding note balance or cumulative losses exceed 2%.

A portion of this first loss fund will be held aside for liquidity. This liquidity amount is sized at 3% of the outstanding rated notes, therefore, only 2% (or 0.06% of the total collateral balance) of the first loss fund is available as credit enhancement at close. The liquidity amount reduces in line with the rated notes, and as such, the excess funds available for credit enhancement are designed to increase as the rated notes amortise. These excess funds are also subject to a PDL trigger which stops them from being used to pay class B note interest, once losses have breached a certain threshold.

In addition, the liquidity amount has triggers such that as the PDL increases above 50% for the relevant note class, the liquidity amount is no longer available to pay interest on that class of note. This PDL trigger does not apply to the class A note. As a result, the excess amount of the first loss fund over the liquidity amount – that is available to use as credit enhancement – increases as these triggers are breached. Only this excess amount over the liquidity amount has been taken into account in the calculation of credit enhancement.

The monies held in the reserve fund will not be held in a guaranteed interest contract (GIC) account but will instead be invested in eligible investments, as Paragon believes it will be able to earn a higher rate of return. Fitch has however assumed a sub-Libor rate of return for the purposes of its cash-flow analysis (which is typically the case for a GIC account).

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, which 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 is further compression of excess spread.

To the extent available, excess spread, after meeting other senior expenses and interest on the class A note tranche, will be available to replenish any debit balances that arise on the PDLs. In addition, the excess spread can be used to pay down the class A and B notes after three years.

Principal to Pay Interest

If there is a shortfall in revenue funds to pay senior fees and interest on the class A and B notes, funds may be reallocated from principal receipts to cover the shortfall. The principal made available to cover these revenue deficits will be recorded on the PDL and is to be recouped from future revenue. Principal funds can only be used in this manner if the relevant class of notes does not have a PDL exceeding 50% of the note balance.

In its cash flow analysis, Fitch has modelled the principal draw mechanism, which is standard among UK RMBS pass-through transactions.

Minimum Mortgage Rate

The administrator must ensure that the WA margin applicable to the mortgages after taking into account all hedging arrangements, income received from the investment of funds in the transaction account, income from early repayment charges and scheduled releases from the margin reserve fund, is not less than three-month sterling Libor plus 4% until August 2019 and three-month sterling Libor plus 4.5% thereafter. Should the WA margin fall below these levels, the mortgage administrator will be obliged to either:

- increase the rates on variable-rate loans in the pool, to ensure sufficient revenue funds are available; or
- make a drawing on the subordinated loan, such that the required levels are met.

Margin Reserve Fund

A margin reserve fund, fully funded at closing, has been established to bring the interest payments on the loans to Libor plus 3.15% for the first two years and Libor plus 4.50% thereafter. The fund also acts to mitigate the cost of carry during the pre-funding period. The funds will be released into the revenue waterfall according to a pre-determined schedule.

Further Advance Pre-Funding Reserve

A further advance pre-funding reserve, fully funded at closing, up to GBP3,000,000 will be established to purchase any discretionary further advances up to any principal determination date, prior to the call option date, designated by PML (as administrator). Any funds remaining in the reserve on any principal determination date prior to the call option date will be released into the principal waterfall.

Early Amortisation Events: Events of Default

The following will constitute an event of default (EoD):

1. non-payment by the issuer of principal in respect of the notes within seven days following the due date;
2. non-payment by the Issuer of any interest amount on the notes within 15 days following the due date;
3. breach of contractual obligations by the Issuer under the relevant documents which is materially prejudicial to the interests of the holders of the most senior class of notes; or
4. an issuer insolvency event which is materially prejudicial to the interests of the holders of the most senior class of notes.

Hedging

Interest-Rate Risk

Payments to be received by the issuer under the loans are subject to variable and fixed rates of interest.

Fixed Rate-to-Three Month Pound Sterling Libor (Hedged)

The issuer will enter into a series of interest-rate swaps to address the possible variation between three-month sterling Libor and the rate of interest earned on the fixed loans. The swap is a non-balance-guaranteed swap. This hedging is based on a scheduled step-down balance in line with the fixed-rate mortgages' amortisation schedule. There may be mismatches on the swap due to prepayments or defaults on the fixed-rate mortgages. Fitch has taken this into account in its analysis.

BBR to Three-Month Sterling Libor (Unhedged)

Bank base rate (BBR)-indexed loans in the PM20 pool will remain unhedged and Fitch has so modelled them. The agency has assumed a conservative 200bp spread from three-month Libor to BBR for the first two years of the transaction, and a spread of 50bp thereafter to account for potential variations in the spread between BBR and three-month Libor.

SVR-to- Three-Month Sterling Libor (Unhedged)

Standard variable rate (SVR) loans in the PM20 pool will remain unhedged and Fitch has so modelled them. The agency has assumed that the long-term spread of SVR loans to three-month Libor is 350bp. This is to account for the margin compression that tends to occur in SVR loans as underlying interest rise and lenders cannot fully track those increases.

Scenario Testing

The capital structure has been stressed in Fitch's rating analysis under certain scenarios, including: high and low CPR scenarios; increasing and decreasing interest-rate scenarios; front and back loaded default curve scenarios.

The stressed scenarios result in no principal losses and the timely payment of interest for each note under each rating category. The most stressful scenarios in the cash flow stress tests are those with an increasing interest rate, high prepayment, and a back-loaded default curve. Fitch has included an additional stress in its high prepayment scenario and assumed a CPR of 30% for the first three years of the transaction, rather than the standard 25%.

Basis Risk

The note coupons are to be set by reference to three-month sterling Libor on 15 February, May, August and November. Meanwhile, the interest rate for new PML-originated Libor-linked mortgages are set by reference to three-month sterling Libor on 1 January, April, July and October. In addition, Idem mortgages are set by reference to three-month sterling Libor on 1 January, April, July and October. As a result, Fitch has applied a 20bp haircut to the margins of these mortgages to account for basis risk.

Counterparty Risk

Fitch performed an on-site operational review of Paragon in February 2014 to assess, among other things, the lender's origination, underwriting and servicing capabilities (see *Appendix B*).

Review visits do not constitute 'due diligence' and Fitch does not perform due diligence but relies upon the accuracy of data given to it.

Servicer

Paragon, as administrator for the PML pool, have delegated its responsibilities to Paragon Finance (PFPLC), which is responsible for administering the mortgage loans in the portfolio.

At the group's West Midlands headquarters, 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. This site has substantial operational history, and Fitch considers PFPLC to be more than adequate in its role as servicer. HML has been designated substitute administrator.

Hedge Providers

Interest Rate Swap

At closing, the issuer will enter into a series of interest rate swaps to eliminate the risk between the fixed rate mortgages and note Libor. This hedging is based on a scheduled step-down balance. The counterparties for the interest-rate swap are Macquarie Bank Limited, rated 'A'/Stable/'F1' and Lloyds Bank plc rated 'A'/Stable/'F1', which satisfy Fitch's expected minimum rating for swap counterparties (detailed in the report entitled *Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum*, published 14 May 2014).

Upon a downgrade of Macquarie Bank Limited or Lloyds Bank plc below Long-Term 'A' or 'F1', one of the following remedial measures must be applied by the swap counterparty:

1. arrangement for a third-party guarantor with the requisite rating;
2. transfer of the swap to a counterparty with the requisite rating;
3. posting of the required collateral to cover the potential loss upon its default; or
4. take such other action as will result in the rating of the notes being maintained or restored.

Only actions (1) and (2) are available upon a downgrade below investment grade. Where collateral is a feasible mitigant — for example, where the swap provider is rated at least investment grade — posting is expected to be effected within 14 calendar days upon the downgrade of the counterparty below 'A' or 'F1'. Where collateral cannot be used as a mitigant, remedial action is expected to be taken within 30 calendar days upon the downgrade of the counterparty.

The swap documents include a clause that allows other unspecified actions, in addition to specific remedial actions, upon the breach of certain thresholds. This clause states that there could be alternative remedies that might be pursued so that a rating downgrade would not occur. Fitch does not consider this clause to have any credit quality effect. The agency will always expect compliance with the provisions of its counterparty criteria upon rating threshold triggers being breached. If remedies as specified in the counterparty criteria are not pursued within specified timeframes, Fitch will analyse the impact of this non-compliance in its rating opinion, and a rating action could follow.

Commingling Risk

Collections Account and Account Bank

Borrower payments on PML mortgages are transferred from the servicer's collection account (at Barclays Bank plc) to the transaction account (also at Barclays Bank plc) within one business day. Borrower payments for Idem mortgages are also transferred from the servicer's collection account (at National Westminster Bank plc) to the transaction account (Barclays Bank plc) within one business day.

The transaction documentation states that should the short-term IDR of the collection account provider fall below 'F2', or its long-term IDR fall below 'BBB+', the collection account must be transferred to an eligible counterparty. Paragon has confirmed that borrower notification is not required to affect a redirection of direct debit payments. However, borrower payments are clustered at the end of the month and Fitch has assumed the loss of one month's worth of scheduled interest to account for this concentration. Thus, in combination with the daily cash sweep, this framework complies with Fitch's reduced exposure criteria on commingling risk (see *Counterparty Criteria for Structured Finance and Covered Bonds*, May 2014, and available at www.fitchratings.com).

Under the transaction documents, Paragon, as the transaction administrator, is required to undertake the replacement of counterparties including the issuer account bank, qualified investments, collection account bank and derivative counterparty if the counterparties cease to fulfil criteria defined in the transaction documentation. The criteria defined in transaction documentation relate both to specific minimum ratings (eg 'A'/'F1', which are consistent with Fitch's counterparty criteria where the highest rated note is 'AAAsf') and to Fitch's counterparty criteria. This mechanism deviates from Fitch's criteria in that the transaction documents include specific references to Fitch criteria (see *Criteria Updates* in *Counterparty Criteria for Structured Finance and Covered Bonds*) rather than being self-contained.

The reference to Fitch criteria creates a degree of uncertainty regarding future counterparty arrangements but Fitch does not expect this mechanism to negatively affect note ratings so long as the administrator maintains counterparties that are consistent with Fitch's counterparty criteria. Fitch highlights that as a result of the mechanism the replacement of counterparties by the administrator may be affected by a change to the rating of the highest-rated note or a change in the agency's criteria. For example, if the highest rated note was 'Asf' the administrator may be expected to apply a lower minimum rating of 'BBB+'/'F2' to the counterparties. A change in the level of minimum counterparty IDR specified in Fitch criteria may also affect the actions of the administrator.

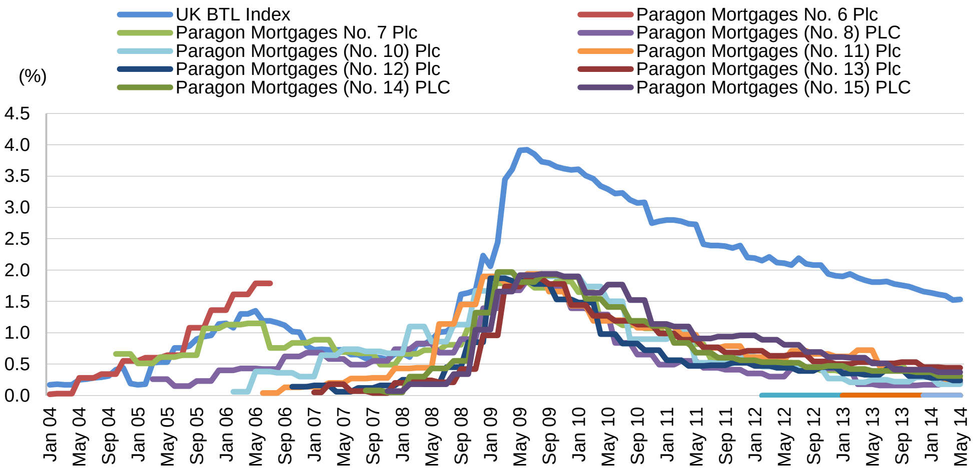
Performance Analytics

The performance of transactions in the Paragon series remains comparable with one another, with each performing well, and better than most other UK BTL transactions. At end-April 2014 the percentage of loans in arrears by three months or more was between 0% (Paragon 16, 17, and 18) and 0.49% (Paragon 13) of their respective outstanding collateral balances. Paragon's extensive use of ROR policies has contributed to the relatively low level of arrears across the series.

Prepayment rates in PM16 spiked in the first half of 2014 (see Figure 5). These prepayments are largely driven by a specific feature of Paragon loans originated immediately after the global financial crisis, which included a mandatory switch from interest-only to repayment after predetermined period (typically five years). As BTL is largely an interest-only market, this creates an incentive for borrowers to refinance.

Figure 4

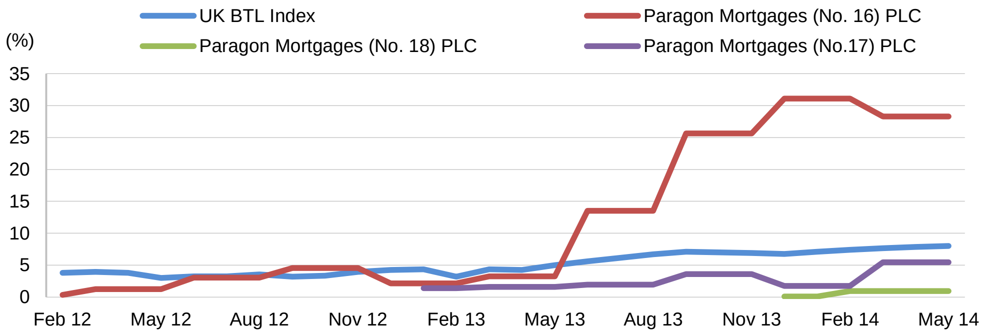
UK BTL 3M+ Arrears



Source: Fitch

Figure 5

Paragon Series CPR



Source: Fitch

Related Criteria

Figure 6
Publications[a]

General rating and structured finance criteria	
Global Structured Finance & Covered Bonds Rating Criteria Hierarchy	20 May 2014
Counterparty risk criteria	
Counterparty Criteria for Structured Finance and Covered Bonds	14 May 2014
Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum	14 May 2014
Interest rate criteria	
Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds	23 January 2014
Mortgage insurance criteria	
Global Criteria for Lenders' Mortgage Insurance in RMBS	23 June 2014
Country-specific criteria	
Criteria Addendum: UK – Residential Mortgage Loss and Cash Flow Assumptions	30 May 2014
EMEA Residential Mortgage Loss Criteria	28 May 2014
Country-specific market studies	
UK Residential Property Value Analysis - A Detailed Review of Sold Properties in Possession	28 February 2013
Surveillance	
EMEA Issuer Report Grades – The Results	11 October 2012
Origination and servicing	
Rating Criteria for Structured Finance Servicers	30 January 2014
Criteria for Servicing Continuity Risk in Structured Finance	29 July 2013

All the above research is available at www.fitchratings.com
[a] Criteria can be updated or amended: Readers should always make reference to the latest criteria available at www.fitchratings.com
Source: Fitch

Appendix A

Figure 7
Transaction Comparison

	PM20[c]	PM19	PM18	PM17
Closing date	**July 2014**	**March 2014**	**September 2013**	**October 2012**
Total issuance (GBP)	**350,000,000**	**350,000,000**	**273,000,000**	**199,568,741**
Preliminary credit enhancement %				
AAA	8.81	10.56	12.8	15.5
AA	2.06	6.06	7.1	10.25
A	n.a.	2.06	2.1	5.25
BBB	n.a.	n.a.	n.a.	n.a.
Initial reserve (% of initial balance)	3.0	3.0	3.0	3.0
Target after arrears/loss triggers	4.0	4.0	4.0	4.0
Liquidity	yes	yes	yes	yes
WAFF (%)				
AAA	21.0	21.0	22.6	20.5
AA	17.0	17.0	18.4	16.6
A	12.6	13.1	14.1	12.8
BBB	8.6	9.2	9.9	9.0
WALS (%)				
AAA	66.1	69.9	70.2	68.3
AA	60.6	63.8	64.9	62.7
A	52.9	56.4	57.0	54.6
BBB	47.5	51.4	51.7	48.9
WARR (%)				
AAA	49.2	48.0	47.6	49.6
AA	54.7	53.1	52.9	55.2
A	60.2	58.1	58.3	60.7
BBB	65.6	63.1	63.7	66.4
WAMVD (%)				
AAA	64.5	64.5	61.9	61.2
AA	60.7	60.8	57.9	57.2
A	56.9	57.2	54.0	53.2
BBB	53.1	53.5	50.0	49.2
Portfolio				
Collateral balance (GBP)	239,405,320	321,681,614	272,981,182	199,568,741
Average current balance per borrower (GBP)	171,617	155,658	169,448	227,041
WA original valuation (GBP)[a]	216,125	198,353	204,478	241,685
Largest indexed valuation (GBP)	1,684,098	2,987,058	3,085,168	2,620,862
WA seasoning (months)[a]	18	32	4	8
L/OM/SE concentration (%)[a]	43.4	57.2	54.9	47.4
WA OLTV (%)[a]	71.0	69.6	72.9	69.9
WACLTV (%)[a]	70.4	70.9	72.8	69.6
WACLTV (indexed values) (%)[a]	67.0	68.5	72.3	69.5
WAOLTV>80% (%)[a]	3.1	4.9	0.6	0.5
WAOLTV>90% (%)[a]	0.1	0.6	0.0	0.00
WA ICR (%)[b]	101.4	89.3	82.9	88.1
WA DTI (%)	n.a.	30.8	n.a.	n.a.
WA stabilised margin (%)	4.7	4.1	4.7	4.7
Interest-only loans (%)	90.8	92.2	93.4	93.5
Buy-to-let (%)	100.0	97.9	100.0	100.0

[a] As calculated by Fitch
[b] As calculated by Paragon using Fitch's interest rate assumption of 4% plus the relevant margin. Note that the stress rate for previous deals was 5.5%
[c] Final pool characteristics as expected at the end of the prefunding period
Source: Fitch and pool cuts provided by Paragon

Appendix B: Origination, Underwriting and Servicing

Origination

Paragon Mortgages Limited (PML) and Mortgage Trust Limited (MTL) are subsidiaries of the Paragon Group, which specialises in the provision of various financial products to consumers. As a mortgage company, PML specialises in the origination of BTL products through intermediaries, and since February 2001 the vast majority of originations have been to professional borrowers. Since September 2010, a new originator, Paragon Mortgages (2010) Limited has focused on the professional landlord market. To qualify for the benefits of such a loan a borrower must already have a portfolio of at least three properties and must present a minimum of two years' 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.

For new originations, the rental income from single, self-contained properties must be a minimum of 125% of the mortgage payment calculated on an interest only basis, at either the product rate, or a reference rate of 5%, whichever is the higher. The rental income for all other property types must be a minimum rental income of 130% of the mortgage payment calculated on an interest only basis, at either the product rate, or the reference rate of 7%, whichever is the higher.

PML has five levels of underwriting based on a hierarchy of mandates. To increase borrowings above these levels it may request additional information, such as a business plan or performance data or conduct an interview with the applicant. Large exposures, ie in excess of GBP2m, to single borrowers are monitored via an annual review of accounts, letting conditions, voids, demand, cash flows, as well as a consideration of the borrower's strategy for the next 12 months. These controls are designed to ensure PML is kept abreast of the performance of key borrowers' portfolios, and may mitigate against single obligor concentration within the reference portfolio.

As with other BTL lenders, PML prefers to retain manual discretion in its lending procedures rather than adhere to a pro forma approach. As such, a hierarchy of mandates adhering to guidelines and criteria is in place to ensure that accountability is maintained. At the heart of policy-making is the overarching credit committee - comprising four standing members and other experts, that are called upon as appropriate, - which convenes on a monthly basis and presides over any changes to criteria and special cases.

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

Underwriting

PML has its own dedicated underwriting team where the underwriters are usually recruited from within the business, and receive one-on-one on-the-job training. If the underwriters are new to the business, it is expected they will need six months training prior to receiving a lending mandate. Monthly sample checks are completed against all underwriters by line management and further random checks are undertaken immediately after completion of a loan. Other control mechanisms are in place on the systems to ensure mandates and lending thresholds are not over-ridden.

HUNTER has been used as a fraud detection tool since 1995 however a successful switch to SIRA (Syndicated Intelligence for Risk Avoidance) occurred during 2006 and is still in place today. Since its re-entry into the buy to let market in 2010, Paragon has introduced a fraud policy to ensure both fraud prevention controls and compliance with regulatory requirements is in place.

Property Valuation

The Paragon Group has 18 regionally based staff surveyors who complete the majority of valuations; the remainder are completed by "panel" surveyors. It is expected that more unusual properties are surveyed by the staff surveyors. All surveys completed by panel surveyors are audited by a Paragon staff surveyor.

Servicing

PFPLC invested in sophisticated collections technology after adverse credit experience in the early 1990s. At the group's West Midlands headquarters, 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. This site has substantial operational history, Fitch considers PFPLC more than adequate in its role as servicer.

PFPLC is not a Fitch-rated servicer of residential mortgage loans. For more information on Fitch's servicer rating programme see the reports titled *Global Rating Criteria for Structured Finance Servicers*, dated 30 September 2009 and *Rating Criteria for European Residential and Commercial Mortgage Loan Servicers – UK Market Addendum*, dated 28 January 2008.

Early Arrears Management

The servicing team currently manages the Paragon and MTL portfolios. Collectors will not see the loan unless it fails a direct debit payment. When that happens for the first time, a telephone call will be made to the borrower within 24 hours to attempt to rectify the situation.

Serious Arrears Management

If the borrower is two months in arrears, Paragon will appoint a Receiver Of Rent (property agent) on the entire portfolio of the borrower. No court approval is required for this. Paragon will send a surveyor with a property agent to the property and inform the tenant that they have to send their rent to the ROR, who forwards it on to Paragon, instead of paying the landlord. No monies from that point onwards are allowed to be passed on to the borrower. Payments received in excess of monthly mortgage payment are used to prepay the loans. A locksmith will also change the locks to the property where the property is not tenanted and a decision will be made to either rent or sell the property.

Even if the borrower becomes current at a later date, Paragon will not usually release the receiver of rent, which effectively forces a borrower to redeem all the mortgages with Paragon.

Foreclosure, Repossession and Sale

Once receiver of rent is appointed, the property cannot be sold if a tenancy is in effect unless it is in the best interests of the debt. At the end of the tenancy, Paragon could theoretically extend the tenancy if it chose to, but usually they would obtain vacant possession and sell the property.

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 monitors that adequate arrangements are in place to ensure continued servicing in the instance that the named servicer in a transaction is unable to perform its duties. HML is the standby administrator.

Appendix C: Transaction Overview

Paragon Mortgages (No.20) PLC — UK/Prime RMBS

Figure 8

Capital Structure

Class	Rating	Size (%)	Size (GBPm)	CE (%)	Interest rate	PMT freq	Maturity	Margin (%)
A	AAAsf	91.25	TBD	8.81	3-month Libor	Quarterly	Nov 2041	TBD
B	AA-sf	6.75	TBD	2.06	3-month Libor	Quarterly	Nov 2041	TBD
D	NR	2.00	TBD	n.a.	3-month Libor	Quarterly	Nov 2041	TBD
Reserve fund		3%						
Liquidity ledger		3% of class A and B						
First interest payment date		15 Nov 2014						
Issuer call date		15 Aug 2018						

Source: Transaction documents

Key Information

Closing date	July 2014	**Parties**	
Country of assets	UK	**Sellers**	Paragon Mortgages (2010) Limited and Idem Capital Securities Limited
Country of SPV	UK	**Servicer**	Paragon Finance plc
Structure	Sequential	**Arrangers**	Macquarie Bank Limited, London Branch and Lloyds Bank plc
Settlement	T+3	**Joint lead managers**	Lloyds Bank plc, Macquarie Bank Limited, London Branch and Morgan Stanley
Listing	London Stock Exchange	**Principal paying agent**	Citibank, N.A., London Branch
Analysts	Shomas Kayani	**PML Collection account/Transaction account**	Barclays Bank plc
	Michael Htun	**Swap counterparties**	Macquarie Bank Limited and Lloyds Bank plc

Source: Transaction documents

Summary

Rating drivers

- **Fully Buy-to-Let Portfolio:** The portfolio consists entirely of BTL loans. Fitch continues to stress the portfolio's default rates beyond those of a prime owner-occupier portfolio at all rating levels, despite the historically lower arrears of past Paragon deals.
- **High Prepayments Modelled:** PM16 has exhibited a high observed conditional prepayment rate (CPR), which exceeds Fitch's typical high CPR stress. PM16 loans, after a specified period, feature a mandatory switch from interest-only to repayment. This provides an incentive for the borrower to refinance. The high CPR scenario is the most stressful, and is therefore a key rating driver. Fitch has modelled the transaction to withstand a high CPR stress.
- **Paragon Transactions Performing Well:** RMBS transactions with loans originated by Paragon have historically performed strongly with low arrears and defaults. Fitch considers the good performance favourably, and has factored this into its analysis (see *Performance Analytics* below for further details)..
- **Unrated Originator and Seller:** The originator and seller are not rated entities and as such may have limited resources available to repurchase any mortgages in the event of a breach of Reps and Warranties (RW) given to the Issuer. Whilst Fitch considers this a weakness, there are a number of mitigating factors that make the likelihood of a RW breach remote (see Page 4)

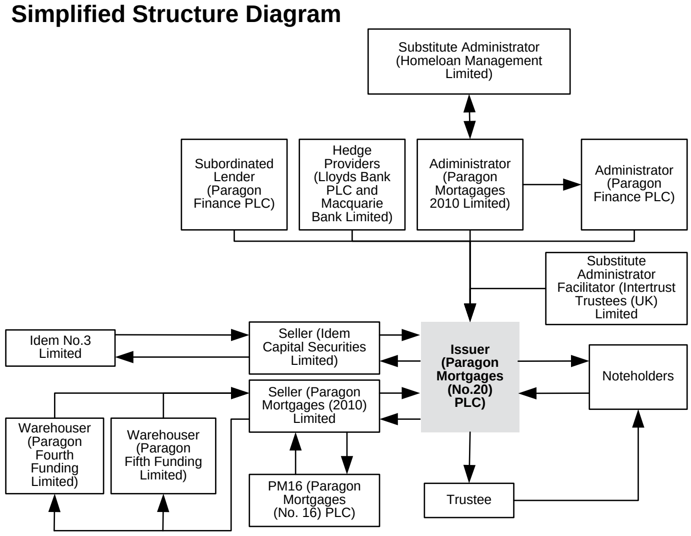
Source: Transaction documents provided by Paragon

Fitch Default Model Output (Static Pool)

Rating level	AAA	AA	A	BBB
WAFF (%)	20.9	17.0	12.6	8.6
WARR (%)	49.2	54.7	60.2	65.6
Loss severity (%)	66.1	60.6	52.9	47.5
MVD	64.5	60.7	56.9	53.1

Source: Transaction documents

Simplified Structure Diagram



Source: Transaction documents

Collateral Summary

Final pool characteristics (As of 31 May 14)

Original principal balance[a]	242,016,383	**Regional concentration (%)**	
Current principal balance [a]	239,405,320	London, SE & OM	43.4
Average current loan per borrower	171,617	South West	10.9
Number of borrowers[a]	1,395	East Anglia	9.9
Number of loans[a]	1,613	North West	9.5
Seasoning (years)[a,]	1.5		
Loan to value (LTV) (%)		**Lien position**	
WA OLTV	71.0	First ranking	100.0
WA CLTV	70.4	Jumbo (%)	18.9
Mortgage characteristics		**Payments**	
WA ICR[a,b]	101.4	Payment frequency	Monthly
Buy to Let (%)	100.0	Payment method	Direct debit
		Performing loans (%)	99.7
Interest rate type			
Floating rate loans (%)	75.5	**Employment status**	
Fixed rate loans (%)	24.5	Self-employed (%)	53.8

[a] Based on provisional pool, and not the expected final pool at the end of the prefunding period
[b] As calculated by Paragon using Fitch's interest rate assumption of 4% plus the relevant margin
Source: Pool Data provided by Paragon

The ratings above were solicited by, or on behalf of, the issuer, and therefore,
Fitch has been compensated for the provision of the ratings.