

RatingsDirect®

Presale:

Paragon Mortgages (No. 21) PLC

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Standard & Poor's 17g-7 Disclosure Report

Related Criteria And Research

Presale:

Paragon Mortgages (No. 21) PLC

Mortgage-Backed Floating-Rate Notes

This presale report is based on information as of Oct. 28, 2014. The ratings shown are preliminary. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings.

Class	Prelim. rating*	Prelim. class size (%)	Available credit enhancement (%)§	Interest	Optional call date	Legal final maturity
A	AAA (sf)	87.65	12.41	Three-month LIBOR plus a margin	December 2018	June 2042
B	AA (sf)	7.10	5.31	Three-month LIBOR plus a margin	December 2018	June 2042
C	A (sf)	2.75	2.56	Three-month LIBOR plus a margin	December 2018	June 2042
D	NR	2.50	0.06	Three-month LIBOR plus a margin	December 2018	June 2042

*The rating on each class of securities is preliminary as of Oct. 28, 2014, and subject to change at any time. We expect to assign final credit ratings on the closing date subject to a satisfactory review of the transaction documents and legal opinion. Standard & Poor's ratings address timely receipt of interest and ultimate repayment of principal. §This is the initial credit enhancement. TBD--To be determined. NR--Not rated.

Transaction Participants

Seller	Paragon Mortgages (2010) Ltd.
Warehouses	Paragon Fourth Funding Ltd., Paragon Fifth Funding Ltd., and Paragon Sixth Funding Ltd.
Administrator	Paragon Mortgages (2010) Ltd.
Substitute administrator	Homeloan Management Ltd.
Substitute administrator facilitator	Structured Finance Management Ltd.
Subordinated lender	Paragon Finance PLC
SFM corporate services provider	Structured Finance Management Ltd.
Paragon corporate services provider	Paragon Mortgages (2010) Ltd.
Issue services provider	Paragon Finance PLC
Hedge providers	Macquarie Bank Ltd. and Lloyds Bank PLC
Transaction account provider and collection account provider	Barclays Bank PLC
Trustee	Citicorp Trustee Company Ltd.
Principal paying agent	Citibank, N.A., London Branch
Registrar	Citibank, N.A., London Branch
Arrangers	Macquarie Bank Ltd., London Branch and Lloyds Bank PLC
Joint lead managers	Lloyds Bank PLC, Macquarie Bank Ltd., London Branch, Morgan Stanley & Co. International PLC, and Natixis S.A.
Holdings	Paragon Mortgages (No.21) Holdings Ltd.
Share trustee	SFM Corporate Services Ltd.

Supporting Ratings

Institution/role	Ratings
Barclays Bank PLC as transaction account provider and collection account provider	A/Negative/A-1
Macquarie Bank Ltd. as hedge provider	A/Stable/A-1
Lloyds Bank PLC as hedge provider	A/Negative/A-1

Transaction Key Features*

Expected closing date	November 2014
Collateral	U.K. buy-to-let mortgage loans
Principal outstanding of the provisional pool (mil. £)	153.124
Country of origination	England and Wales
Concentration (%)	Southeast England and London: 57.82
Property occupancy	Buy-to-let 100.00%
Weighted-average indexed current LTV ratio (%)§	71.93
Weighted-average original LTV ratio (%)§	72.30
Average loan size balance (£)	153,585
Loan size range (£)	57,820 to 1,000,075
Weighted-average seasoning (months)	1.37
Weighted-average asset life remaining (years)	20.34
Weighted-average current mortgage loan interest rate (%)	
Arrears of more than one-month (%)	0.00
Redemption profile	Interest only (less than 10 years): 4.16% Interest only (10 years or more): 88.08% Repayment: 7.76%
Cash reserve (%)†	2.5 (see explanation in relevant section)
Postcode concentration	2.96% SW1 and 2.05% SE1
Mortgage loan priority	First-ranking

*Data is based on a provisional pool as of Sep. 30, 2014 (see "Transaction Summary"). §LTV calculations are based on Standard & Poor's methodology. †We understand that the cash reserve will not be amortizing when we assign final ratings. At closing, 0.06% of the cash reserve will be available to cover losses. LTV--Loan-to value.

Transaction Summary

Standard & Poor's Ratings Services has assigned preliminary credit ratings to Paragon Mortgages (No. 21) PLC's (PM 21) class A, B, and C notes. At closing, PM 21 will also issue unrated class D notes.

The collateral pool comprises first-ranking buy-to-let mortgages that Paragon Mortgages (2010) Ltd. (Paragon) originated between July and September 2014.

At closing, the issuer will use the class A to D notes' proceeds to purchase £153.12 million of mortgage loans from Paragon. We also anticipate that the issuer will add additional mortgages to the pool before closing. After closing, we expect that the issuer will use any remaining proceeds from the notes to purchase Paragon's prefunded loans.

In assigning our preliminary ratings, we only incorporated Paragon's £153.12 million existing pool. During the prefunding period, we note that the issuer will use the notes' proceeds that exceed the initial mortgage portfolio

balance to purchase newly-originated Paragon mortgage loans.

Under the transaction documents, the issuer may acquire these additional mortgages until the second interest payment date, provided that the additional mortgage loans' credit quality and concentration do not adversely affect the transaction's cash flow analysis results. As we have not stressed a "worst-case" pool, any noticeable deterioration could prevent us from providing a rating agency confirmation. Consequently, the issuer would instead use the amount in the pre-funding reserve to repay principal early, in sequential order.

If the issuer does not use all of the notes' proceeds during the prefunding period to purchase the additional loans, then it will use the outstanding amounts to amortize the notes according to the principal priority of payments on the subsequent interest payment date.

Paragon will be the mortgage administrator. Homeloan Management Ltd. will be the substitute administrator.

As a result of the prefunding, the pool's credit quality may change between closing and the end of the prefunding period. The pool's composition could change further owing to the purchase of further advances during the transaction's life. Under the transaction documents, further advances can be added if the addition does not increase original loan-to-value (LTV) ratio by more than 1%. This condition somewhat mitigates the risk of credit deterioration. In our analysis, we factored in the possible increase in LTV ratios due to further advances.

In our analysis, we considered the transaction's structural features, as well as its exposure to counterparty and operational risks. The results indicate that the available credit enhancement for the rated tranches is sufficient to mitigate the credit and cash flow stresses at the assigned preliminary rating levels.

Notable Features

Paragon, a specialized and experienced buy-to-let lender and servicer, originated a number of transactions before 2007, but stopped originating mortgages between 2008 and 2010. PM 21 will be the fourth transaction from Paragon that we have rated since 2007, and Paragon's sixth securitization since it resumed lending in 2010.

All of the loans in the pool are currently in their fixed or discount period; 63.66% pay a fixed rate of interest, and the remaining 36.34% pay at a rate linked to LIBOR.

After the end of the fixed or discount period, all of Paragon's loans will revert to a rate linked to LIBOR plus a variable margin, floored at LIBOR plus a variable margin. Under the documentation, borrowers may apply for a product switch and the administrator is not required to buy back affected mortgages, but would need to cash collateralize the margin reserve ledger for any decreased interest rate product.

The transaction does not have a basis risk swap in place. Therefore, the portion of Paragon's loans that are linked to LIBOR (both before and after the reversionary date) will be exposed to basis risk. This risk arises as the LIBOR on the notes resets three months before the interest payment date (IPD), while the assets reset on the first day of January, April, July, and October, resulting in a weighted-average 37-day mismatch. We have considered these risks in our analysis.

Strengths, Concerns, And Mitigating Factors

Strengths

- In our view, Paragon is an experienced buy-to-let mortgage loan originator.
- Paragon's transactions have been outperforming buy-to-let transactions that we rated since March 2010.
- Homeloan Management will be a back-up servicer for the transaction. We rank Homeloan Management as ABOVE AVERAGE as a mortgage servicer. In addition, Structured Finance Management Ltd. will be the substitute administrator facilitator.
- The cash collateralization mechanism guarantees a margin of 300 basis points (bps) over three-month LIBOR over the first two years, and 450 bps thereafter.

Concerns and mitigating factors

- All of the pool's mortgage loans are buy-to-let mortgages. Buy-to-let properties are exposed to different foreclosure risks than owner-occupied properties. These risks include the borrower's level of reliance on the rental receipts to meet mortgage payments and the borrower's prior experience in managing rental properties. We have considered these features in our analysis.
- Credit support is provided by the first loss liquidity excess amount (FLLEA) of the first loss fund (FLF). The required balance of the FLF will not amortize for the life of the transaction. At closing, the FLLEA will amount to 0.06% of the closing note balance. The FLLEA is the amount that remains after the liquidity amount (2.5% of the balance of the A, B, and C notes) is deducted from the FLF. As the A, B, and C notes amortize, this liquidity amount reduces, increasing the required balance of the FLLEA. The use of the FLLEA for the class B and C notes is subject to the principal deficiency ledgers (PDLs) on these notes not exceeding 50% of the outstanding balance of the relevant class of notes.
- The required balance of the FLF can increase to 4% of the closing note balance if 60+ days delinquencies are greater than 3% or cumulative losses exceed 2% of the notes' original principal amount, subject to available excess spread. Subordination and excess spread will provide most of the credit support for the notes.
- Some of the loans in the pool will pay a rate of interest linked to three-month LIBOR, either during the discount period, after the switch to the final rate, or during both periods. The LIBOR rate used to determine the mortgage rate for these loans may be lower than the LIBOR rate used to calculate the interest rate on the notes. This basis risk is not hedged in this transaction. We have incorporated this risk in our analysis.
- During the prefunding period, the portfolio's credit quality could deteriorate if the issuer were to purchase new loans of lower credit quality. Paragon requires a rating agency confirmation as a condition precedent to acquire the prefunded portion. This limits the risk of a deterioration in the portfolio's quality.
- Of the loans in the preliminary portfolio, 15.13% are larger than in a typical U.K. RMBS transaction; large loans are secured against properties with larger-than-average valuations. We stressed jumbo valuations (above £500,000 in the south of the U.K. and above £312,500 in the north) in our loss severity analysis because we consider jumbo properties to be less liquid, attracting higher repossession market value declines (RMVDs).
- The pool's seasoning is very low, as Paragon originated the mortgages between July and September 2014. We associate seasoned loans with a lower likelihood of foreclosure relative to those that are not well seasoned (but that are otherwise the same). We view a mortgage's initial five years as being the most stressful period for a borrower.
- The transaction may acquire further advances, up to 5% of the notes' outstanding balance, granted to borrowers. Under the transaction documents, further advances can be added if the addition does not increase original LTV ratio by more than 1%. This condition somewhat mitigates the risk of credit deterioration. In our analysis, we factored in the possible increase in LTV ratios due to further advances.
- On Feb. 16, 2014 a subsidiary of the Paragon Group of Companies (Paragon Bank) was granted a banking license

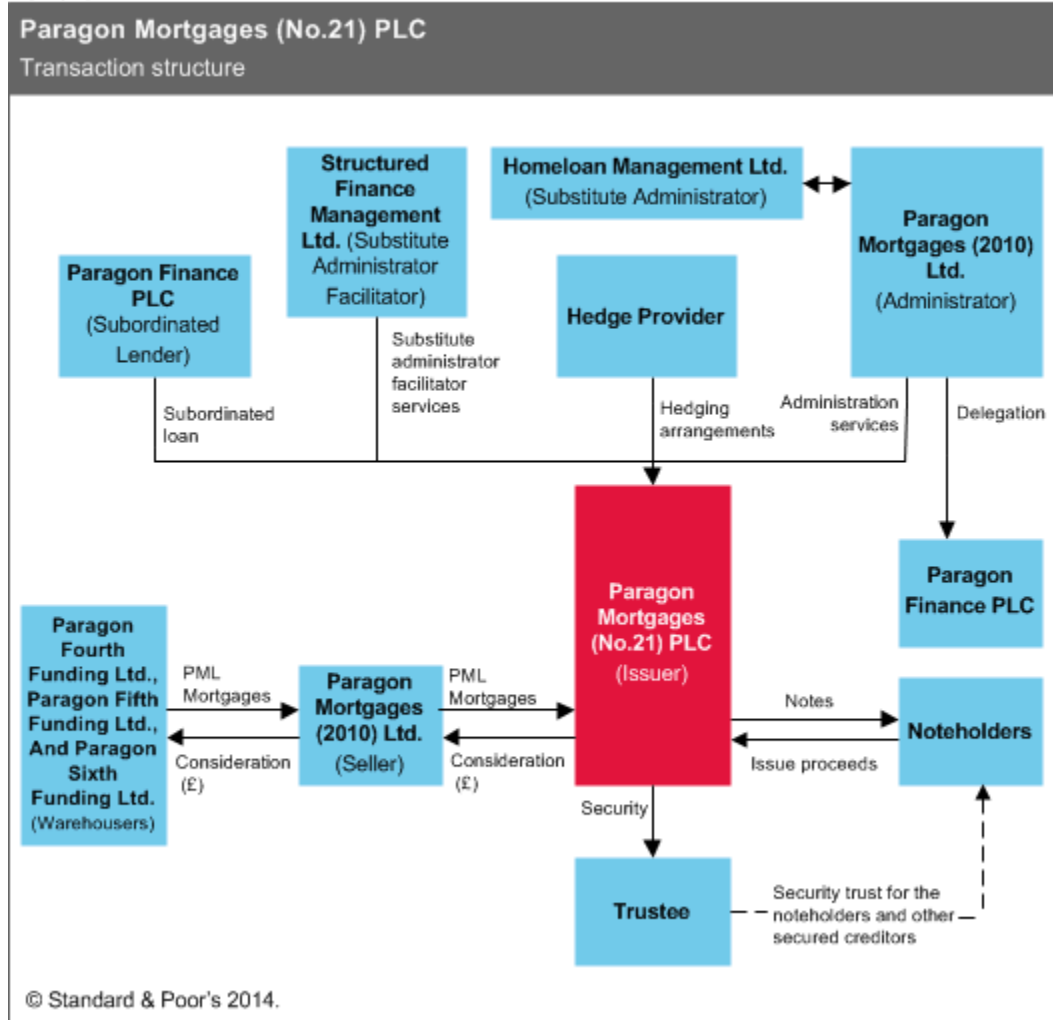
from the Prudential Regulation Authority (PRA). This license permits Paragon Bank to accept deposits. As Paragon Bank is a separate legal entity from the other Paragon companies and does not have a role in the transaction structure, we do not consider this development to have any effect on our analysis.

Transaction Structure

At closing, PM 21 will acquire the beneficial interest in the mortgage loan pool from the seller. PM 21 will issue the class A, B, C, and D notes to fund the purchase of the portfolio. PM 21, in common with Paragon Mortgages (No.17) PLC (PM 17), is an "orphan" special-purpose entity (SPE). PM 21 has a similar structure to Paragon Mortgages (No.19) PLC (PM 19).

The issuer will grant security over all of its assets in favor of the security trustee (see chart 1).

Chart 1



Seller and portfolio administrators

Paragon will act as the seller in this transaction. The Paragon Group Of Companies, through its subsidiary, Paragon, will act as mortgage administrator. The seller will also hold legal title to the relevant mortgage loans until a perfection of title event occurs.

As part of our standard corporate overview, we conducted a review of Paragon Group's origination, underwriting, and valuation processes, as well as its default-management procedures in October 2014. We are satisfied that Paragon, Mortgage Trust Services, and Homeloan Management are capable of performing their functions in the transaction.

Product switches

The administrator may agree to a borrower's request to convert the mortgage loan's interest rate type to, for instance another fixed rate mortgage. A product switch with a lower interest rate than then minimum weighted-average interest rate could be granted without previously funding the conversion reserve fund with the required amount. In order to mitigate this risk, on the last business day of each calendar month, the administrator shall identify any proposed interest rate converted mortgage and transfer the conversion required amounts to the transaction's margin reserve fund ledger by drawing on the subordinated loan agreement. The product switch occurs once the conversion reserve fund is at its required level (including the new proposed converted mortgage). Product switches cannot occur in the transaction if the margin reserve fund is not at its required level (including the additional proposed conversion mortgage). The ability to convert mortgages does not transfer to any replacement administrator.

Notes Terms And Conditions

The notes will pay interest quarterly in arrears on the 15th day of March, June, September, and December each year, with the first IPD on March 15, 2015.

Optional redemption of the notes

The issuer may redeem all the notes at their principal amount outstanding, together with any accrued interest on or after the IPD in December 2018. There will be no step-up margin in this transaction, although from December 2018 excess spread will be used to pay down the outstanding notes.

Mandatory redemption of the notes

The issuer will apply available principal receipts to redeem the notes at each IPD, subject to the principal priority of payments.

Clean-up call

The issuer may redeem all the notes at their principal amount outstanding together with any accrued interest, if the total outstanding balance of the notes is less than 10% of the original balance of all notes at closing.

Amortization of the notes

We expect PM 21 to pay principal receipts sequentially to the noteholders, with the class A notes being redeemed prior to subordinated classes.

Collateral Description

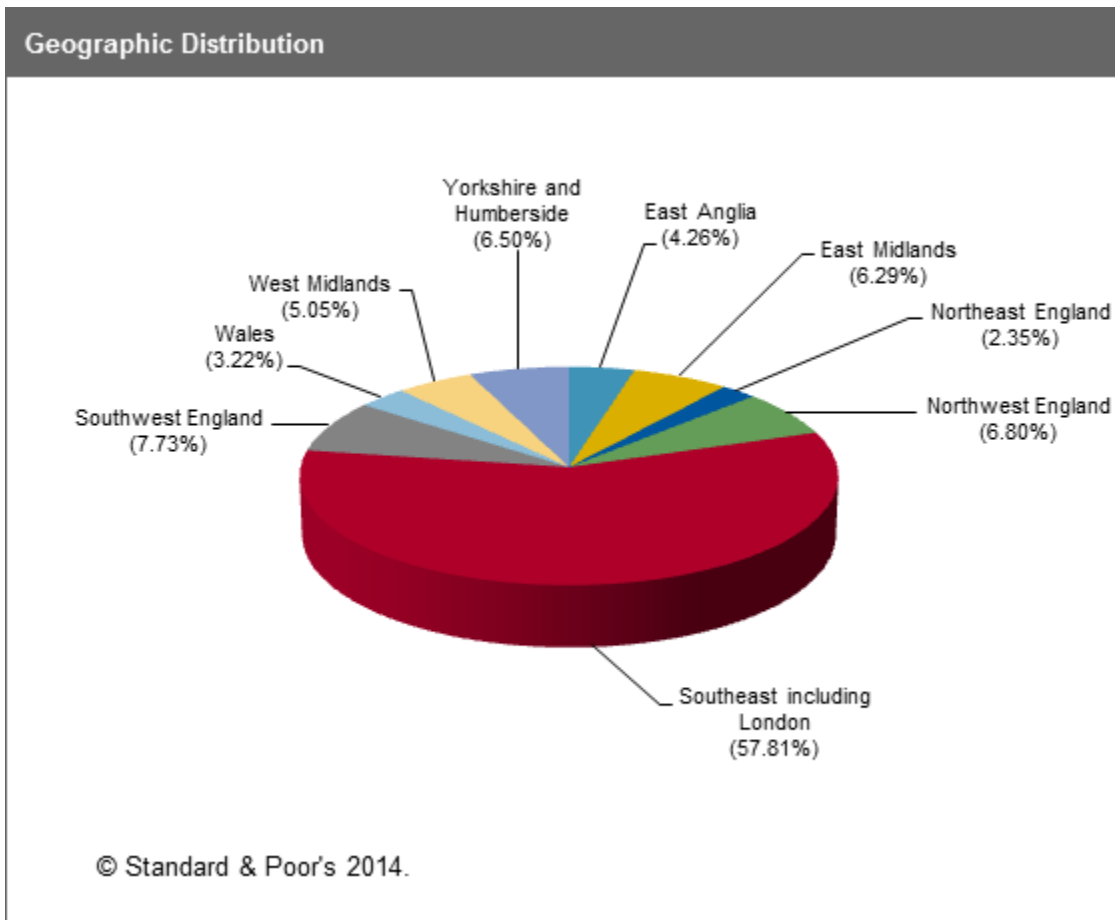
The preliminary pool includes £153,124,043 of mortgage loans that Paragon originated between June and September 2014. We associate seasoned loans with a lower likelihood of foreclosure relative to those that are not well seasoned (but that are otherwise the same). We view a mortgage's initial five years as being the most stressful period for a borrower.

The portfolio has a weighted-average indexed current loan-to-value (LTV) ratio of 71.94%. Although this ratio is in line with PM 19 (72.50% for Paragon's portion of the pool), U.K. house prices have since increased, while income growth has been moderate. This has resulted in increased RMVDs. For all buy-to-let mortgage loans, the rental income from the property securing the loan has been verified. All of the loans in the pool are current.

A feature of the portfolio is the high variety of buy-to-let mortgages. These include professional landlords and lets by individuals through personal or corporate loans (usually through SPEs that are guaranteed by directors). We consider the originator's underwriting levels to be conservative, but the nature of the buy-to-let market creates additional risks compared with a typical prime owner-occupied mortgage portfolio (such as reliance on tenants to make timely rental payments), notwithstanding the weighted-average LTV ratio of this portfolio. These risks are mitigated by Paragon's good understanding of the market as a specialist lender, its conservative buy-to-let underwriting policy, and its dominant position in the professional landlord sector, in our view.

The preliminary pool is 57.82% concentrated in southeast England and London (see chart 2). This concentration is above the level that we consider to be excessive (52.00%), and we have therefore made adjustments for this in our analysis.

Chart 2



The weighted-average original LTV ratio of the collateral in the preliminary pool is 72.30% (see chart 4). We consider that borrowers with minimal initial equity in their property are less likely to be able to refinance, and are more likely to default on their obligations than borrowers with lower original LTV ratio loans. At the same time, loans with high current indexed LTV ratios are likely to incur greater loss severities if the borrower defaults. In the preliminary pool, 89.55% of the loans have a current indexed LTV ratio of below 80%, and 26.50% have a current indexed LTV ratio of below 70%.

Chart 3

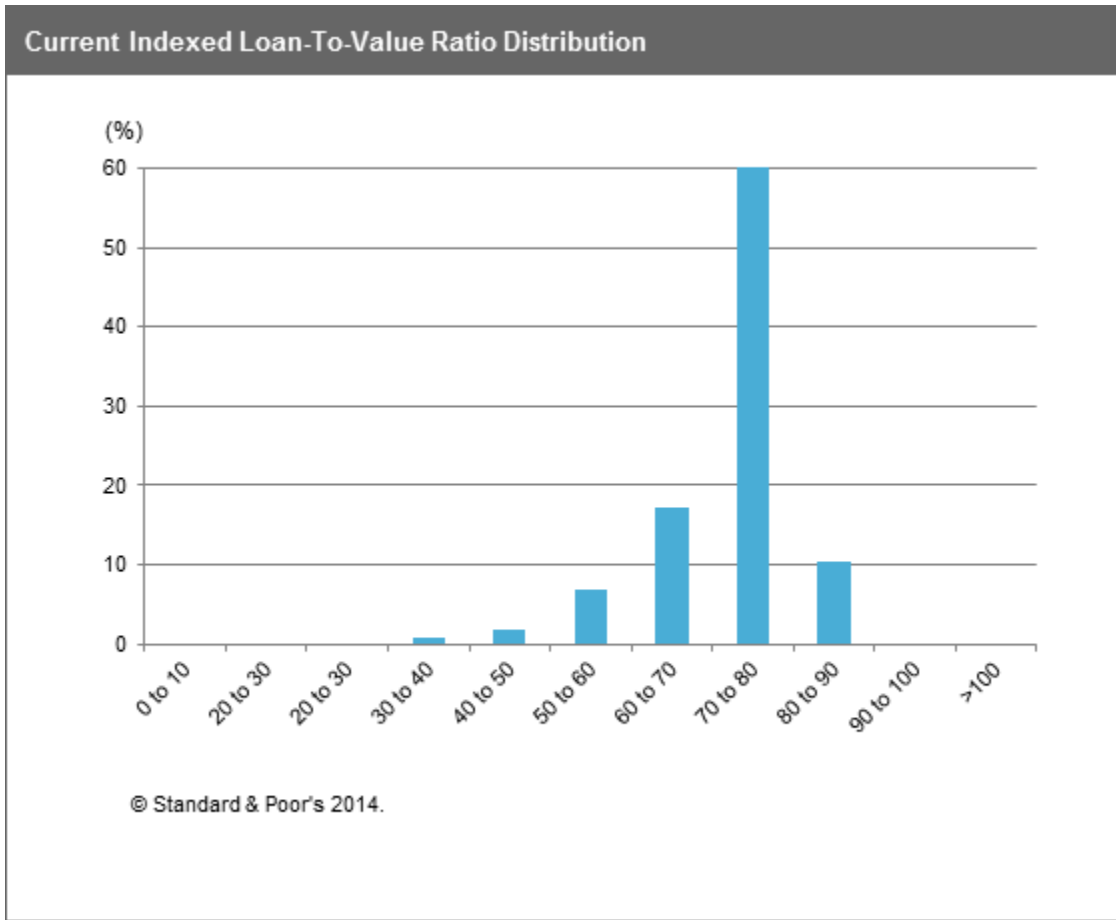
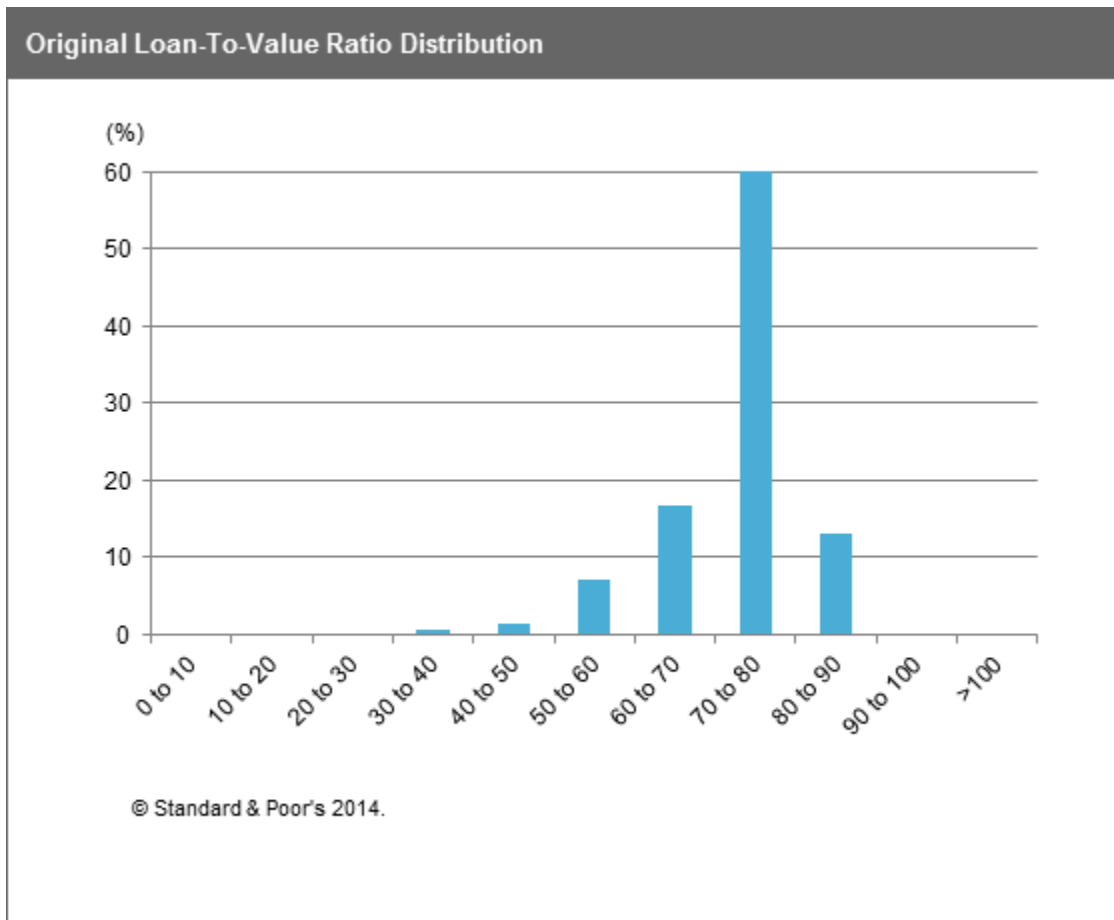
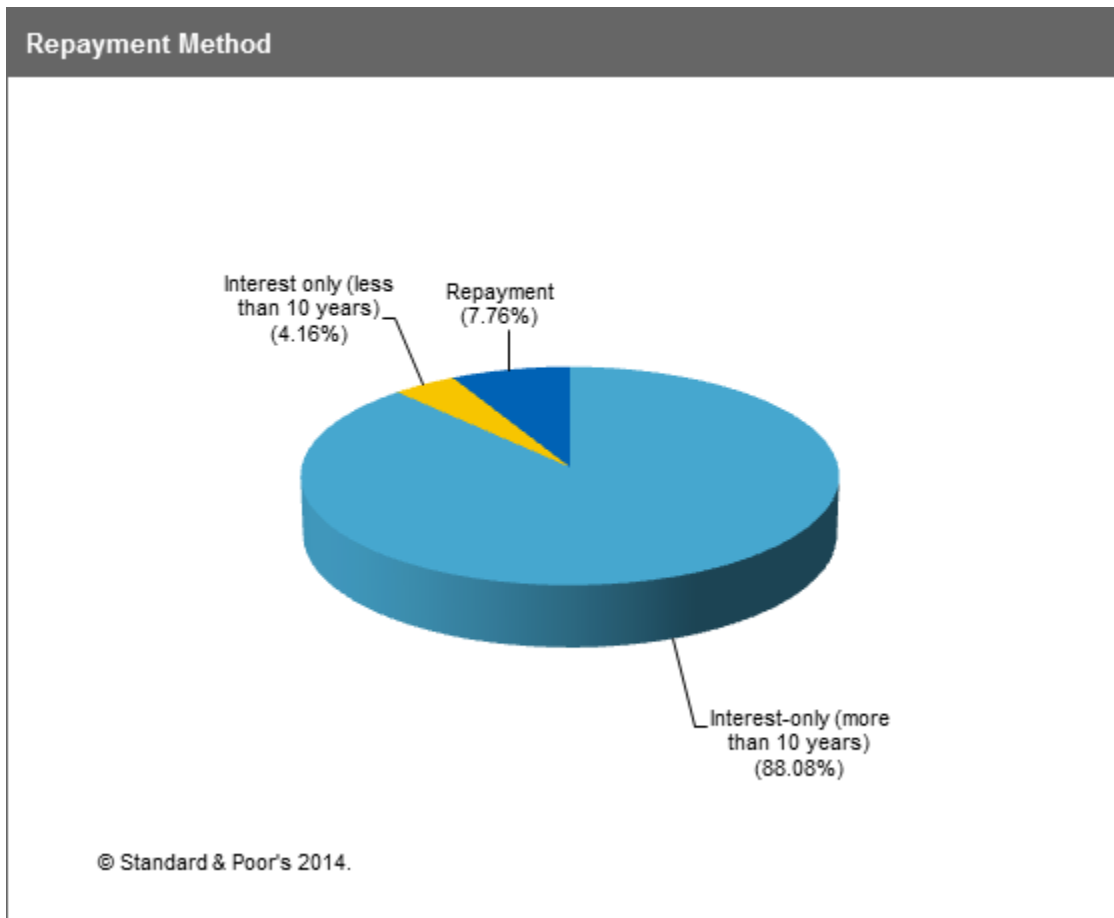


Chart 4



Of the portfolio, 92.24% are interest-only loans. 4.16% of these interest-only loans have a term of less than ten years, which we view as higher risk than repayment or longer-dated interest-only mortgages. Of the preliminary pool, 88.08% are interest-only mortgages with a term of 10 years or more, and 7.75% of the pool are repayment loans. We have accounted for this concentration risk for interest-only loans above 50% by applying an adjustment of 1.5x, as per our criteria (see chart 5).

Chart 5



Prefunding pool

Until the second principal determination date after closing, the issuer will purchase new loans from the seller (Paragon), subject to certain criteria designed to control the credit quality of the aggregate pool, for example, the aggregate current balance of the mortgage of the top 20 borrowers must not exceed £25 million.

On this occasion, we have not modeled a "worst-case" pool, because the issuer's purchase of additional mortgages will be subject to certain criteria under the transaction documents, such as rating agency confirmation that the purchase will not adversely affect the then-current ratings on the notes.

Substitutions

If the servicer identifies a loan as being in breach of the representations and warranties of the relevant seller, the seller will be required to repurchase (or substitute) the loan. Any noticeable deterioration could prevent us from providing a rating agency confirmation.

Credit Structure

A combination of subordination, the reserve fund, and excess spread on the mortgage loans will provide credit

enhancement for the notes (see table 1).

Table 1

Credit Enhancement For The Notes				
Class	Prelim. rating	Size of class (%)	Mil. £ (equivalent)	Initial credit enhancement (%)
A	AAA (sf)	87.65	TBD	12.41
B	AA (sf)	7.10	TBD	5.31
C	A (sf)	2.75	TBD	2.56
D	NR	2.5	TBD	0.06

TBD--To be determined. NR--Not rated.

PM 21 will open both a collection account and a transaction account with Barclays Bank PLC, the bank account provider. Payments by borrowers are received into collection accounts in the names of the sellers, which are held with Barclays Bank.

Any accounts will be subject to the terms of the transaction documents. The administrator will replace Barclays Bank, as the bank account provider, with a suitably rated institution in 60 days, if at any time we lower our long-term issuer credit rating (ICR) on the bank account provider below 'A', where the short-term rating is at least 'A-1'.

Under the transaction documents, the borrowers will make their monthly payments in the seller collection accounts held with Barclays Bank. The transaction documents will establish a declaration of trust over any amounts in the seller collection accounts. Amounts in the collection accounts will be swept daily into the transaction account.

As per the transaction documents, should Barclays Bank no longer have the required rating according to our current counterparty criteria, HSBC Bank PLC have agreed to take over as the bank account provider (should they have the requisite rating at the time) (see "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013).

The replacement framework for the collection and transaction account is in line with our counterparty criteria.

First loss fund

The FLF will be nonamortizing and funded at closing to 2.5% of the initial notes balance. In the FLF ledger, an amortizing amount equal to 2.5% of the rated notes outstanding will represent the liquidity amount and only the difference between the FLF and the liquidity amount will form the FLLEA. This will be available to cure credit losses, whereas the liquidity amount will provide only liquidity support to the rated notes.

The amount available to cure losses, at inception, through the FLLEA is just six bps, but, when the notes start to amortize, we expect the FLLEA to increase in size, following the amortization of the liquidity amount, with more credit enhancement being available to the notes. The use of the FLLEA for the class B and C notes is subject to the PDLs on these notes not exceeding 50% of the outstanding balance of the relevant class of notes.

The required amount of the FLF will increase to 4% of the initial note balance if:

- 60+ days arrears are more than 3% of the current balance of the mortgages in the portfolio; or
- Cumulative losses are equal or greater than 2% of the original balance of the notes.

The issuer will replenish the reserve FLF from excess spread, if available, and principal receipts.

Margin reserve fund and cash collateralization

At closing, the seller will calculate the difference between 300 bps and the weighted-average loan margin (including the post-swap margin for a fixed-rate loan) applied to the outstanding aggregate balance of the loans at closing and for the duration of the first two years of the transaction. At closing, the seller will also calculate the difference between 450 bps and the weighted-average loan margin for the remainder of the transaction after the first two years. The seller will deposit this amount into the margin reserve fund (MRF) held by the issuer.

This purpose of this mechanism is to ensure that the margin on the assets is equal to at least 300 bps during the first two years and at least 450 bps after the first two years. The amount deposited in the MRF will be released on each IPD according to a predefined schedule, irrespective of whether any of the borrowers are delinquent.

At closing, the seller will also deposit in the MRF the amount equal to the difference between the yield earned on the cash held in the prefunding reserve and LIBOR plus 3.00% during the prefunding period. This amount will be released and become part of issuer's revenue funds on the March and June 2015 IPD. The total amount that the seller will deposit into the MRF, based on the current pool, is 0.32% of the initial note balance.

Minimum mortgage rate mechanism

The loans in the Paragon pool are currently either fixed- or floating-rate at LIBOR plus a margin. After the end of the fixed or tracker period, all of the Paragon loans revert to three-month LIBOR. Under the documentation, borrowers may apply for a product switch and the administrator is not required to buy back affected mortgages.

Principal to pay interest

PM 21 can use principal to pay interest if other revenue sources are insufficient for this purpose. If this occurs, the balance would be recorded to the PDL and may reduce the available credit enhancement for the notes. However, the issuer can only use principal to pay interest on all classes of notes, except for the class A notes (on which there are no restrictions on the use of principal to pay interest), if the relevant class' PDL does not exceed 50% of the tranche's size and 100% of all classes of notes ranking junior to it.

Priority of payments

The revenue priority of payments will be as follows:

- Senior fees;
- Swap payment;
- Class A interest;
- Class A PDL;
- Class B interest;
- Class B PDL;
- Class C interest;
- Class C PDL;
- Issuer profit amount;
- Class D PDL;
- FLF top-up; and
- Subordinated payments (including the class D notes' interest, sub loan interest, swap defaulted termination)

payments, and deferred purchase consideration).

The principal priority of payments will be as follows:

- Top up liquidity amount (part of the FLF) if required;
- Further advances;
- Class A principal;
- Class B principal;
- Class C principal;
- Class D principal; and
- Subordinated loan principal.

After the call option in December 2018, PM 21 will use excess revenue after the topping up of the FLF to pay down the rated notes.

Principal deficiency ledger

The PDL will comprise four subledgers: The class A notes' PDL, the class B notes' PDL, the class C notes' PDL, and the class D notes' PDL. Losses (or use of principal receipts and the liquidity amount) will first be allocated to the PDL in reverse order of seniority with the class D PDL being debited first.

Further advances

The transaction allows for both mandatory and discretionary further advances to be granted. The structure allows the issuer to purchase discretionary further advances of up to 5% of the notes' original balance, subject to having sufficient funds to do so. The addition of further advances is subject to the same conditions that we described above in relation to the purchase of prefunded loans. Under the transaction documents, further advances can be added if the addition does not increase original LTV ratio (as of the second principal determination date) by more than 1%. This condition somewhat mitigates the risk of credit deterioration. In our analysis, we factored in the possible increase in LTV ratios due to further advances.

Hedging Risk

Fixed-to-floating swap

The issuer will enter into a series of fixed-to-floating swaps with Macquarie Bank Ltd., and Lloyds TSB. Under the swaps, the issuer will pay a fixed rate of interest in exchange for the three-month LIBOR that is used to determine the coupon on the notes.

The notional of the swaps at closing will roughly correspond to the balance of fixed-rate loans in the pool.

The notional of the swaps will amortize following a predefined schedule regardless of the prepayments or defaults on the fixed-rate loans.

All of the swaps are in line with our current counterparty criteria.

Credit And Cash Flow Analysis

We stress the transaction's cash flows to test the credit and liquidity support that the assets, subordinated tranches, and cash reserve provide.

We apply these stresses to the cash flows at all relevant rating levels. For example, this transaction incorporates tranches that we rate 'AAA', 'AA', 'A', and 'NR' (not rated). We therefore apply one set of cash flow stresses. In our stresses on the 'AAA' rated notes, all notes must pay full and timely principal and interest. However, this is not necessarily the case for the tranches rated 'AA (sf)', because they are subordinated in the priority of payments. The class B and C notes' interest payments may be deferred, if the issuer has insufficient funds to make payments on any IPD. However, our preliminary ratings are based on timely interest and ultimate principal payment.

Credit enhancement

The 'B' credit enhancement level for the standard U.K. mortgage loan pool is commensurate with our current assumptions of expected losses on that pool (see "U.K. RMBS Methodology And Assumptions," published on Dec. 9, 2011). These expected losses vary according to changes in the outlook for the U.K. mortgage market and cover macroeconomic factors such as unemployment, inflation, and current mortgage performance, among other factors. The current 'B' level of credit enhancement includes a foreclosure frequency component for the standard U.K. mortgage loan pool, as shown in table 2. We used the assumptions in table 5 as part of our credit analysis of the underlying assets in this transaction.

Table 2

Assumptions	
Rating level	Base foreclosure frequency component for an archetypical U.K. mortgage loan pool (%)
AAA	12.0
AA	8.0
A	6.0
BBB	4.0
BB	2.0
B	1.5

Amount of defaults and recoveries

We model the foreclosure frequency for each loan in the pool, as well as the amount of loss upon the subsequent sale of the property (the loss severity, expressed as a percentage of the outstanding loan). We model a default of the total mortgage loan balance. We determine the total amount of the unrecovered defaulted balance for the entire pool by calculating the weighted-average foreclosure frequency (WAFF) and the weighted-average loan severity (WALS). When comparing the minimum credit enhancement levels that we consider commensurate with each rating level with that of this pool, we also included interest foregone between the point of default and the receipt of recoveries (see table 3).

Table 3

Assumptions		
Rating level	Minimum credit enhancement level (%)	Initial credit enhancement modeled for this pool (%)
AAA	4.0	12.41
AA	2.5	5.31
A	1.5	2.56

The WAFF and the WALs increase in tandem with the rating level because notes with a higher rating should be able to withstand a higher level of mortgage default and loss severity. Our credit analysis is based on the characteristics of the loans and the associated borrowers, as well as our subsequent assessment of the WAFF and the WALs for this portfolio, which were the inputs that we used in our cash flow analysis (see table 4).

Table 4

Portfolio WAFF, WALs, And Credit Enhancement			
Rating level	WAFF (%)	WALS (%)	Credit enhancement (%)
AAA	27.88	47.80	12.41
AA	19.04	40.77	5.31
A	14.28	28.94	2.56

WAFF--Weighted-average foreclosure frequency. WALs--Weighted-average loan severity.

For modeling purposes, the repossession market value declines that we apply under our criteria to calculate the loss severity incorporate our calculation of the degree of over- or under-valuation for each U.K. region (see "U.K. RMBS Methodology And Assumptions," published on Dec. 9, 2011). Table 5 shows the resulting market value declines that we used in our analysis of this pool.

Table 5

Repossession Market Value Declines At 'AAA', 'AA', And 'A' Rating Levels			
Region	AAA (%)	AA (%)	A (%)
East Anglia	53.28	49.23	41.77
East Midlands	51.38	47.62	40.43
Northeast England	48.79	45.42	38.61
Northwest England	50.52	46.89	39.82
Northern Ireland	43.25	40.32	33.95
Scotland	44.97	42.02	35.63
Southeast England (including London)	63.48	57.91	48.95
Southwest England	58.39	53.58	45.36
Wales	52.18	48.30	40.99
West Midlands	50.43	46.81	39.76
Yorkshire and Humberside	45.94	42.98	36.58

Default timings

At each rating level, the WAFF specifies the total balance of the mortgage loans that we assume to default over the transaction's life. We model these defaults to occur over a three-year recession. Further, we test the effect of the timing of this recession on the ability to repay the liabilities by starting the recessionary period at closing and the start of year

3.

We apply the WAFF to the principal balance outstanding at the closing date. We model defaults to occur periodically, in amounts calculated as a percentage of the WAFF. The timing of defaults follows two paths, referred to as "front-loaded" and "back-loaded" (see table 6).

Table 6

Default Timings For Front-Loaded And Back-Loaded Default Curves		
Recession month	Front-loaded defaults (percentage of WAFF per month)	Back-loaded defaults (percentage of WAFF per month)
1–6	5.0	0.8
7–12	5.0	0.8
13–18	3.3	1.7
19–24	1.7	3.3
25–30	0.8	5.0
31–36	0.8	5.0

WAFF--Weighted-average foreclosure frequency.

Timing of recoveries

We assume that the issuer regains any recoveries 12 months after a payment default for buy-to-let properties. The value of recoveries at each rating level is 100%, minus the WALs for that rating level.

The WALs that we use in the cash flow model is based on principal loss, including foreclosure costs. We do not give credit for the recovery of any interest accrued on the mortgage loans during the foreclosure period. After we apply the WAFF to the balance of the mortgage loans, we find that the asset balance is likely to be lower than that of the liabilities. Our test shows that the interest reduction caused by the defaulted mortgage loans during the foreclosure period is covered by the transaction's other structural mechanisms.

Delinquencies

We model the liquidity stress that results from short-term delinquencies (those mortgage loans that cease to pay for a period of time, but then recover and become current with respect to both interest and principal). To simulate the effect of delinquencies, we model a proportion of scheduled collections equal to one-third of the WAFF to be delayed. We apply this in each of the first 18 months of the recession, and model full recovery of these delinquencies to occur 36 months after they arise. Therefore, if the total scheduled collateral collections expected to be received is £1 million and the WAFF is 30% in month five of the recession, £100,000 (one-third of the WAFF) is delayed until month 41.

Interest and prepayment rates

We model five different interest rate scenarios—up, down, up-down, down-up, and forward curve. We model three prepayment scenarios at all rating levels—high, low, and forecast. During the recessionary period, we model the prepayment rate at 3%, before gradually reverting to a high prepayment rate under both scenarios. At the 'AA' level and above, we model an additional low prepayment scenario, which also reverts to a low prepayment rate after the recession period. For this transaction, we modeled the forecast constant payment rate as 1.26%. This figure is based on the average constant prepayment rate we observed in earlier Paragon transactions and First Flexible No.4 over the past year. Given this, we have also considered the scenario in which the prepayment rate both during and after the

recession is 1.26%.

In combination, the default timings, recession timings, interest rates, and prepayment rates described above give rise to 60 different scenarios at a 'AAA' rating level (see table 7). The ratings we assign mean that the notes have all paid timely interest and ultimate principal under each of the scenarios at the assigned rating level.

Table 7

RMBS Stress Scenarios						
Rating level	Total number of scenarios	Prepayment rate	Recession start		Interest rate	Default timing
'AAA'	60	High, expected, and low	Closing and year 3.		Up, down, up-down, down-up, forward for standard run.	Front-loaded and back-loaded
'AA-' and below	40	High and low	Closing and year 3.		Up, down, up-down, down-up, forward for standard run	Front-loaded and back-loaded

Given the transaction's structure, the more stressful scenario for our cash flow analysis is a high collateral prepayment rate in an increasing interest rate environment.

Scenario Analysis

Various factors could lead us to lower our ratings on the notes, such as increasing foreclosure rates in the underlying pool, and changes in the pool composition. We have analyzed the effect of increased delinquencies by testing the sensitivity of the ratings to two different levels of movements.

Increasing levels of delinquencies will likely cause more stress to a transaction, and would likely be a contributing factor in the downgrade of rated notes.

In our analysis, our assumptions for the increase in delinquencies are specific to a transaction, although these levels may be similar (or the same) across different transactions. The levels do not reflect any views as to whether these deteriorations will materialize in the future; however, our analysis already incorporates additional adjustments to the default probability of the pool by projecting buckets of expected arrears.

Note that even under these scenarios, structural features in securitizations may mitigate these deteriorations in performance.

Further delinquencies of 8%

In the first scenario, in addition to the rating-dependent stress assumptions, we apply a further 8% increase in nonperforming loans. These are split equally between the one-month and three-month buckets. In the second scenario, we apply an increase of 8%, but all the loans are deemed to have missed three monthly payments. The default probability we assign to a loan increases in tandem with the monthly payments missed. As a consequence, assuming that all loans have missed three monthly payments, the increase in the WAFF would be greater in the second scenario.

Table 8

Assuming An Additional 8% Of Arrears, Split Equally Between One Monthly Payment And Three Monthly Payments Missed		
Preliminary rating on the notes	WAFF (%)	WALS (%)
AAA	32.88	47.80
AA	23.04	40.77
A	17.08	28.94

WAFF--Weighted-average foreclosure frequency. WALS--Weighted-average loan severity.

Table 9

Assuming An Additional 8% Of Arrears, All Of Which Have Missed Three Monthly Payments		
Rating level	WAFF (%)	WALS (%)
AAA	35.88	47.80
AA	25.04	40.77
A	18.28	28.94

WAFF--Weighted-average foreclosure frequency. WALS--Weighted-average loan severity.

Under the first scenario, the ratings on the notes in the transaction would not suffer a ratings transition of more than one level (for example, the 'AAA' rated notes would achieve a rating of at least 'AA').

Under the second scenario, the ratings on the notes would not suffer a rating transition of more than two levels (for example, the 'AAA' rated notes would achieve a rating of at least 'BBB').

Under scenario one, the class A notes pass at a 'AA+' rating level, the class B notes pass at a 'A+' rating level, and the class C notes pass at a 'A' rating level.

Under scenario two, the class A notes pass at a 'AA+' rating level, the class B notes pass at a 'A+' rating level, and the class C notes pass at a 'A' rating level.

These rating movements are in line with our credit stability criteria.

It should be noted that we based the analysis above on a simplified assumption, i.e., that the increase in arrears materializes immediately on the day after closing. In reality, these are likely to occur over a period of time. Therefore, other factors, such as seasoning or repayments of some loans, could partially mitigate the effect of deteriorating performance of other loans.

Sectoral Credit Highlights

In Q2 2014, the U.K.'s buoyant economy boosted the performance of the U.K. RMBS transactions in Standard & Poor's Ratings Services' index. However, stagnant wages and looming interest rate rises could put borrowers under pressure in the coming quarters.

The U.K.'s strong 0.8% GDP growth in Q2 2014 resulted in the U.K. economy surpassing its previous peak in Q1 2008, as a result of strong consumer spending, a falling savings rate, as well as increasing corporate investment and exports. We believe that growth will reach 2.9% in 2014, before decelerating to 2.5% in 2015, and 2.1% in 2016, respectively

(see "Low Interest Rates Are Underpinning Europe's House Price Recovery," published on July 28, 2014).

Unemployment fell by an impressive 1.4% over the past 12 months to 6.4%. Between February and April, employment surged 345,000, the largest gain in 40 years. However, this has not translated into higher earnings.

We expect the housing market to continue to strengthen going forward, albeit more moderately. The Financial Policy Committee introduced further limitations on mortgage lending to the Mortgage Market Review in June. These included limits on the proportion of loan-to-income multiples of 4.5x and above, to no more than 15% of a lender's mortgage book. These combined measures will, at least temporarily, weigh on house price growth. We expect U.K. house prices to increase by 7.0% in 2014, before decelerating to 4.5% in 2015.

It remains to be seen if policy measures adopted by policy makers (and some banking groups themselves) are having an effect on house price growth. While Nationwide's monthly house price readings as of July 2014 indicate a cooling in house price growth, Halifax reported another 1.4% rise in July. Furthermore, the Bank of England's data show that mortgage approval levels rose for the first time in the five months to June 2014.

We expect collateral performance to remain stable overall in 2014, but looming interest rate rises could bring about downside risk.

The level of arrears in the underlying collateral backing U.K. buy-to-let RMBS transactions remained stable in 2013. The prepayment rate for these transactions increased to 5% in Q4 2013, up from 3.6% 12 months previously, reflecting the market's buoyancy.

We expect collateral performance to remain stable overall in 2014

Surveillance

We will maintain surveillance on the transaction until the notes mature or are otherwise retired. To do this, we will analyze regular servicer reports detailing the performance of the underlying collateral, monitor supporting ratings, and make regular contact with the servicer to ensure that it maintains minimum servicing standards and that any material changes in the servicer's operations are communicated and assessed.

The key performance indicators in the surveillance of this transaction are:

- Increases in credit enhancement for the notes;
- Total and 90-day delinquencies;
- Cumulative realized losses;
- LTV ratios;
- Constant prepayment rates; and
- Increases in the seasoning of the collateral pool.

Standard & Poor's 17g-7 Disclosure Report

SEC Rule 17g-7 requires an NRSRO, for any report accompanying a credit rating relating to an asset-backed security as defined in the Rule, to include a description of the representations, warranties and enforcement mechanisms available to investors and a description of how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities.

The Standard & Poor's 17g-7 Disclosure Report included in this credit rating report is available at:
<http://standardandpoorsdisclosure-17g7.com>.

Related Criteria And Research

Related criteria

- Europe Asset Isolation And Special-Purpose Entity Criteria--Structured Finance, Sept. 13, 2013
- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- U.K. RMBS Methodology And Assumptions, Dec. 9, 2011
- Methodology: Credit Stability Criteria, May 3, 2010

Related research

- European Structured Finance Scenario And Sensitivity Analysis 2014: The Effects Of The Top Five Macroeconomic Factors, July 8, 2014
- Global Structured Finance Scenario And Sensitivity Analysis: Understanding The Effects Of Macroeconomic Factors On Credit Quality, July 2, 2014
- Europe's Housing Markets May Be On A Slow Path To Recovery, Jan. 22, 2014
- U.K. RMBS Index Report, published quarterly

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