



## RATING ACTION COMMENTARY

# Fitch Upgrades Paragon Mortgages (No. 25) and Paragon Mortgages (No. 26)

Mon 12 Sep, 2022 - 6:13 AM ET

Fitch Ratings - London - 12 Sep 2022: Fitch Ratings has upgraded Paragon Mortgages (No. 25) PLC's class D notes and Paragon Mortgages (No. 26) PLC's class B notes. In addition, Fitch has removed all notes from Under Criteria Observation (UCO) as detailed below.

## RATING ACTIONS

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

C XS1785821940	LT	AA-sf Rating Outlook Stable	AA-sf Rating Outlook Stable
		Affirmed	
D XS1785822088	LT	A+sf Rating Outlook Stable	BBB+sf Rating Outlook Stable
		Upgrade	
Paragon Mortgages (No. 26) PLC			
A1 XS1938530646	LT	AAAsf Rating Outlook Stable	AAAsf Rating Outlook Stable
		Affirmed	
A2 XS1938530729	LT	AAAsf Rating Outlook Stable	AAAsf Rating Outlook Stable
		Affirmed	
B XS1938531024	LT	AAAsf Rating Outlook Stable	AA+sf Rating Outlook Stable
		Upgrade	
C XS1938531370	LT	A+sf Rating Outlook Stable	A+sf Rating Outlook Stable
		Affirmed	

[VIEW ADDITIONAL RATING DETAILS](#)

## TRANSACTION SUMMARY

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

## KEY RATING DRIVERS

**Upgrades Reflect New Criteria:** The rating actions follow the removal of the notes from UCO. Under its latest UK RMBS Rating Criteria published on 23 May 2022, Fitch

updated its sustainable house prices for each of the 12 UK regions. The changes resulted in increased regional multiples for all regions other than north east and northern Ireland. The criteria also include updated house price indexation and gross disposable household income. The sustainable house prices are now higher in all regions except northern Ireland. This has had a positive impact on recovery rates and, consequently, Fitch's expected loss and contributed to the upgrades.

**Stable Asset Performance:** Asset performance has remained strong, with arrears by more than one monthly payment at 0.62% (Paragon 25) and 0.57% (Paragon 26) as of April 2022. Given the BTL nature of the underlying pool, borrowers in arrears by more than two months are predominantly managed by Paragon via its receiver of rent policy, where the full rental stream is diverted to Paragon, as administrator, and used towards clearing arrears.

Paragon's extensive use of its receiver of rent policy has therefore contributed towards the low level of delinquencies across the series. Prepayments for both transactions have not peaked at as high levels as previous Paragon transactions, as the pools are still mostly on a fixed rate.

**Revolving Transaction, Trigger Breached:** Paragon 25 is in the final year of its five-year revolving period, which allows new assets to be added to the portfolio. While the replenishment criteria mitigate risks about the potential negative migration of the portfolio's credit profile, the risk remains for some deterioration during the revolving period.

Since January 2021, one of the additional loan conditions for the purchase of new assets was breached and no new mortgages have since been added to the pool. Under the revolving conditions, the balance of loans paying or reverting to the standard variable rate (SVR) has to remain below 75% while it reached 84.8% as of April 2022. While the breach can be cured, considering the limited time left in the revolving period and the current magnitude of the breach, Fitch has no longer stressed the portfolio characteristics for its analysis.

**Class A Scheduled Amortisation:** After the first year of fully revolving period, credit enhancement (CE) has started to build up, in line with scheduled amortisation from August 2019. Principal on Paragon 25's class A notes will be paid according to a target scheduled amortisation until the end of the revolving period in May 2023, while the remaining principal amounts (if any) can be used by the issuer to purchase new assets, subject to meeting the substitution criteria. The build-up in CE, combined with the stable performance and pool characteristics, contributes to the upgrades.

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

**Error Corrected:** The affirmation of Paragon 25's class B and C notes and the upgrade of the class D notes include the correction of an error. Fitch previously made an error in the modelling of the swap rate assumed for the hedging agreements entered to hedge future product switches. The swap rate modelled was lower than intended and had resulted in higher excess spread in the transaction and, ultimately, a higher rating for Paragon 25's class B, C and D notes.

## **RATING SENSITIVITIES**

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

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

Additionally, unanticipated declines in recoveries could also result in lower net proceeds, which may make certain note ratings susceptible to negative rating action, depending on the extent of the decline in recoveries. Fitch tested a sensitivity scenario by applying 15% increase in the weighted average foreclosure frequency (WAFF) and a 15% decrease in the weighted average recovery rate (WARR). The results indicated downgrades of up to two notches for Paragon 25 and of up to three notches for Paragon 26.

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

Stable to improved asset performance driven by stable delinquencies and defaults would lead to increasing CE levels and, potentially, upgrades. A decrease in the WAFF of 15% and an increase in the WARR of 15% indicated upgrades of up to two notches for Paragon 25 and no impact for Paragon 26.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Structured Finance transactions have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of seven notches over a three-year rating horizon; and a worst-

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

## **CRITERIA VARIATION**

For Paragon 25 Fitch varied its constant prepayment-rate assumptions, as outlined in its UK RMBS Rating Criteria, for the remaining year of the revolving period to match the target scheduled amortisation of the class A notes during the revolving period. The application of the variation has had no rating impact.

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

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

## **DATA ADEQUACY**

Fitch has checked the consistency and plausibility of the information it has received about the performance of the asset pools and the transactions. Fitch has not reviewed the results of any third- party assessment of the asset portfolio information or conducted a review of origination files as part of its ongoing monitoring.

Prior to the transactions' closing, Fitch reviewed the results of a third-party assessment conducted on the asset portfolio information and concluded that there were no findings that affected the rating analysis.

Prior to the transactions' closing, Fitch conducted a review of a small targeted sample of the originator's origination files and found the information contained in the reviewed files to be adequately consistent with the originator's policies and practices and the other information provided to the agency about the asset portfolio.

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

## **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

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

## **ESG CONSIDERATIONS**

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

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## **APPLICABLE CRITERIA**

[Structured Finance and Covered Bonds Interest Rate Stresses Rating Criteria \(pub. 20 Sep 2021\)](#)

[Global Structured Finance Rating Criteria \(pub. 26 Oct 2021\) \(including rating assumption sensitivity\)](#)

[UK RMBS Rating Criteria \(pub. 23 May 2022\) \(including rating assumption sensitivity\)](#)

[Structured Finance and Covered Bonds Country Risk Rating Criteria \(pub. 15 Jul 2022\)](#)

[Structured Finance and Covered Bonds Counterparty Rating Criteria \(pub. 29 Jul 2022\)](#)

[Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum \(pub. 01 Aug 2022\)](#)

## **APPLICABLE MODELS**

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

Multi-Asset Cash Flow Model, v2.12.2 (1)

ResiGlobal Model: UK, v1.4.0 (1)

## **ADDITIONAL DISCLOSURES**

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## **ENDORSEMENT STATUS**

Paragon Mortgages (No. 25) PLC

UK Issued, EU Endorsed

Paragon Mortgages (No. 26) PLC

UK Issued, EU Endorsed

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