European Structured Finance
New Issue Report

First Flexible No. 4 plc

Ratings

Floating-Rate Mortgage-Backed Notes due 2036

GBP 460,000,000 Class A	AAA
GBP 35,000,000 Class M	A
GBP 5,000,000 Class B	BBB

Analysts

Andrew Jackson
+44 (0)20 7417 6329
andrew.jackson@fitchratings.com

Euan Gatfield
+44 (0)20 7417 6306
euan.gatfield@fitchratings.com

Lead Managers

Nomura International plc

James Drayton
+44 (0)20 7521 2107
james.drayton@uk.nomura.com

Barclays Capital

Simon Wood
+44 (0)20 7773 1181
simon.wood@barcap.com

Company Contact

Britannic Money plc

Andrew Vaughan
+44 (0)1372 730735
andrew.vaughan@britannicmoney.com

Summary

First Flexible No.4 plc's ("the issuer") GBP [500] million mortgage-backed notes are rated as indicated at left. First Flexible No. 4 plc is the fourth issue of notes backed by a pool of UK residential mortgages originated by Britannic Money plc ("BM") (formerly First Active Financial plc) and, in respect of certain investment home loans to corporate borrowers, First Active plc ("FA"). The pool of mortgages contains both buy-to-let and flexible mortgages. The issuer is a special purpose company incorporated and registered in England and Wales with limited liability as a public limited company.

The ratings are based on the quality of the collateral, available credit enhancement, BM's and FA's mortgage underwriting standards and BM's servicing capabilities, as well as the sound legal and financial structure of the transaction. Credit enhancement for the class A notes totalling [9.5]% at closing was provided by the class M notes ([7]%), the class B notes ([1]%) and the reserve account of [1.5]% of original note balance.

At closing, the issuer will acquire a portfolio of residential mortgages, which will subsequently form the collateral for the notes, from Arianty No. 1 plc ("Arianty"), an off-balance sheet subsidiary of BM that previously acquired the pool from BM and FA. The portfolio consists of first-ranking fixed and floating rate mortgage loans, a large proportion of which are flexible and/or buy-to-let mortgages, secured by residential property located in the United Kingdom.

To determine appropriate levels of credit enhancement, Fitch analysed the collateral using a loan-by-loan mortgage default model (see *"UK Residential Mortgage Default Model II"* dated 13 October 2000, available on website *www.fitchratings.com*). The agency also modelled the cash flow contribution from excess spread using stress scenarios determined by its default model. The cash flow test showed that each class of rated notes can withstand loan losses at a level corresponding to the related stress scenario without incurring any principal loss or interest shortfall, after taking available credit enhancement into account.

10 July 2001

Key Strengths, Risks and Mitigants

Strengths

- Low LTV relative to similar UK transactions
- Good performance of previous First Flexible deals
- No loans currently in arrears

Risks

- Redraw risk arising from the rights of 96% of borrowers by current balance to take further redraws to the extent that they have prepaid

Mitigated by: There is a sizeable redraw facility (replenished with trapped prepayments) within the structure to mitigate this risk

- Interest rate and basis risk associated with the array of different products within the pool having different bases and/or discount-, fixed- or capped-rate periods

Mitigated by: The series of interest rate swaps and caps undertaken by the issuer, as well as the base rate, discount and hedge reserves within the structure

- The inclusion of a significant portion of buy-to-let loans entails the likelihood that mortgage repayments are somewhat dependent on the housing cycle and that default probabilities are increased since the collateral are not owner-occupied

Mitigated by: Fitch has taken account of the former by stressing the income class used to generate default probabilities in its matrix on investment loans for which estimated rental yield is less than 150% of mortgage repayments, and then applying a further hit for the latter reason.

Collateral

At closing, the pool forming the collateral for the notes will consist of approximately [5,200] mortgage loans with a total outstanding balance of approximately GBP [427] million. The mortgages represent first ranking liens securing loans originated by BM and FA. There is a large component of investment home loans and flexible mortgages within the pool. The majority of the pool ([97.5]%) were flexible mortgages comprised of drawn and undrawn amounts of the mortgage (see Flexible Mortgages below).]

[There are several mortgage repayment types in the pool. Interest only and Capital and Interest repayment are the commonest types, making up [57.4]% and [41.6]% of the pool respectively. Endowment mortgages comprise [1]% of the pool.]

The pool is geographically concentrated primarily in London/Outer Metro ([39.1]% of the pool) and the South East ([24.2]%) (note that Fitch's regional definitions may differ from those described in the offering circular).

Fixed rate, capped variable rate and discount variable rate loans comprise approximately [71.5]% of the pool. The interest-rate risk associated with such mortgage products is addressed in the Financial Structure section below.

At closing none of the mortgages being securitised will be more than 30 days in arrears. With a flexible mortgage (described below) the borrower is entitled to prepay a scheduled payment, with the option to skip a payment without being considered in arrears. However, such a 'Payment Holiday' has to be agreed with BM or FA.

Key Characteristics of Pool (as of [29 June 2001])	
Aggregate Drawn Balance	GBP [427,156,598]
Aggregate Undrawn Balance	GBP [23,415,998]
Avg scheduled principal balance	GBP [86,466]
Avg actual principal balance	GBP [81,972]
Avg undrawn portion	GBP [4,494]
Loan-to-Value (CLTV) Ratio	[66.1]%
Loan-to-Value (LTV) Ratio (inc. undrawn)	[67.8]%
Wtd Avg Seasoning	[6] months

Flexible Mortgages

The flexible mortgage product affords borrowers the ability to prepay a portion of their principal balance at any point in time (monthly, annually, etc.) and to use the amount prepaid as a line of credit that they can redraw at any point in the future. Some borrowers of interest-only loans may draw to a line of credit limit greater than their original drawdown. In addition, borrowers may take "payment holidays" to the extent that amounts prepaid are used in lieu of scheduled payments. The general limitations, however, include that if the borrower prepays more than 20% (the 'threshold amount') of the scheduled principal balance, a fee of 1% per annum ('commitment fee') will be charged on amounts in

Key Information

Issuer: First Flexible No.4 plc

Originators: Britannic Money plc (BM) and First Active plc (FA) (rated 'A-/F2' by Fitch)

Seller: Arianty No. 1 plc

Trustee: Chase Manhattan Trustees

Provisional Pool Cut-Off Date: [29 June 2001]

Servicer: BM

Redraw Facility and GIC Provider: Barclays Bank plc (rated 'F1+' by Fitch)

Swap Counterparties: The Royal Bank of Scotland (rated 'AA/F1+' by Fitch), Morgan Guaranty and Barclays Bank plc

Interest Payments: Monthly beginning [1 September 2001]

Coupon Step-up: [July 2008]

Legal Maturity: [July 2036]

Collateral: First-ranking residential mortgage loans secured by real property located in the United Kingdom.

excess of the threshold. The borrower may reschedule his loan to avoid such penalties, but the redraw would then not be available. In most cases, and for all newly originated loans, BM and FA hold the right to change both the commitment fee and the threshold level at any time. Pursuant to transaction documentation though, it must maintain 20% as the maximum threshold and 1% as the minimum commitment fee.

Substitution and Further Advances

On any Interest Payment Date up to [July 2004] and in accordance with the priority of payments, the issuer will be entitled to purchase with designated principal collections further mortgages/advances from Arianty, insofar as they satisfy qualifying criteria, and provided that the aggregate balance of mortgages, further mortgages/advances and potential redraws within the pool is less than at the previous determination date.

Substitution is subject to the following conditions:

- The aggregate amount of further mortgages/advances purchased since the last interest payment date not exceeding [3]% of the outstanding aggregate mortgage balance;
- The aggregate amount of further advances not exceeding [10%] of the outstanding aggregate mortgage balance;
- No more than [2.5]% of the outstanding principal amount of the mortgage loans being in arrears of more than £100;
- The amount of interest arrears not exceeding 2% of gross interest due on all mortgages over the last 12 months;
- The latest calculation of the principal deficiency ledger not exceeding 0.1% of the current aggregate balance of mortgages;
- No drawing having been made on the reserve fund in the previous month
- The weighted average loan to value of the portfolio prior to the purchase not exceeding the weighted average of the aggregate LTV ratio at closing plus [1]%;
- The product of WAFFs and WALS increasing by no more than 0.25% from its initial value;
- The geographic concentration within London and the South East not exceeding [80]% by current balance;
- No Rating Agency notification event having occurred.

Prefunding

In addition to the purchased mortgages, the issuer will hold in cash up to GBP [80] million of notes' proceeds allotted entirely for the purchase of mortgages from Arianty by First Flexible 4. Subsequent mortgages will conform to the same criteria imposed on the initial mortgage pool in order not to adversely affect any ratings.

Non-Verified Mortgages

A portion of the initial pool will contain loans that have not yet made a first payment. Loans whose first scheduled payment is not received by the issuer (or the servicer acting on its behalf) by the first interest payment date, will be repurchased by Arianty on that date.

Credit Issues

Fitch analysed the collateral for First Flexible 4 by subjecting the mortgage loans to stresses resulting from its assessments of historical home price movements and defaults in the UK *(see Fitch's Research on "UK Residential Mortgage Default Model II" dated 13 October 2000)*. The analysis is based on the probability of default and loss severity as the main components of expected loss *(see Appendix 1).*

Default Probability

***Buy-to-Let*:** In the provisional pool, approximately [50]% of the loans are secured by properties acting as investments rather than as primary places of residence. Fitch believes that in times of financial distress, a borrower is more likely to default on a mortgage secured by an investment property than on one secured by a first home, and hence increases its assumption of default probability by [25%] on such loans. Furthermore, despite the assurance that applicants dependent on rental income alone to service mortgage repayments will be rejected by the originators, Fitch believes that buy-to-let mortgage repayments are more susceptible to the housing cycle, and as such, Fitch increases default probabilities further unless estimated rental yields exceed 150% of mortgage repayments.

***Balloon Risk*:** Interest-only loans make up [57.4%] of the pool. Fitch believes that such non-amortising products not linked to any repayment vehicle entail a risk of payment shock on maturity, and hence Fitch increases default probabilities by up to 33%.

Loss Severity

***High Value Properties*:** Approximately [18]% of the reference pool is considered by Fitch to be secured on high value ('jumbo') properties, with risk of greater market value declines (MVDs) due to a perceived lack of liquidity and therefore variability in market values for these properties. Fitch increased the MVDs of these loans by [10-30]% based on the value of the property.

***Redraws and Payment Holidays*:** Borrowers of flexible mortgages are entitled to take advantage of their line of credit facility. As discussed, options including redrawing and taking payment holidays are available to borrowers to the extent that they have prepaid. Fitch believes that should borrowers experience financial distress, some may redraw and postpone payments prior to eventual default, and has adjusted its loss severity assumptions accordingly.

Financial Structure

To determine the soundness of the financial structure of the transaction, Fitch examined the various strategies to hedge against interest rate risk, redraw risk and set off risk, all in accordance with the paydown structure of the notes.

Interest Rate Risk

There are two types of interest rate risk present in this transaction: basis risk between BM's and FA's standard variable rate (SVR) and the London Interbank Offered Rate (LIBOR) in addition to the interest rate risk from fixed-rate, capped variable-rate and base rate mortgages.

The servicer, BM, will attempt to hedge these risks by ensuring that if interest expected to be received on the mortgages is less than the threshold rate of LIBOR plus the threshold margin (calculated as the average of [1.2]% weighted on the balance of investment home loans and [1]% weighted on the balance of owner-occupied loans), then this income will be supplemented by a combination of:

- income produced by swaps and caps (taken out with the various swap counterparties), as briefly described below
  - fixed rate mortgages will be allocated a series of interest rate swaps,
  - capped variable-rate mortgages will be allocated a series of interest rate caps,
  - base rate linked mortgages will be allocated a series of interest rate swaps to cover the deficit of the base rate below LIBOR,
  - 3-month LIBOR linked mortgages will be allocated an interest rate swap; and
- income produced from various reserves sized at closing to cover the risks that there are interest shortfalls in excess of what is covered by the various hedging instruments, as briefly described below
  - a hedge reserve of £[] million will be established to cover interest shortfalls arising from an interest rate cap strike not exactly matching the cap rates on corresponding mortgages,
  - a base rate reserve of £[] million will be established to cover interest shortfalls arising from the base rate dipping below LIBOR,
  - a discount reserve of £[] million will be established to cover interest shortfalls arising from discount variable mortgage rates dipping below LIBOR; and

Furthermore, the servicer will agree, where necessary, to reset the SVR to increase revenues to the issuer.

Redraw Risk

A unique and crucial component to this transaction is the requirement for the issuing vehicle to fund borrower redraws throughout the life of the transaction. As prepayments grow, the redraw exposure of the transaction increases. On the other hand, redemptions (of repayment mortgages) will reduce the exposure to redraws since once a borrower redeems a portion of his mortgage, he may not redraw on that amount. A redraw facility will be established at the outset of the transaction to provide a source of funding for future redraws on a monthly basis, insofar as there are funds available, and to the extent of the outstanding balance of the class A notes. The redraw facility is a £[58] million line of credit provided by Barclays Bank plc for the life of the transaction, until [2036].

Sizing the redraw facility is a particular challenge due to the lack of historical data on flexible mortgage borrower behaviour. Fitch's methodology for determining the sufficiency of the redraw facility was influenced by the following assumptions and observations.

The risk in this transaction is of redraws exceeding prepayments (i.e. net redraws) in any given period, producing the need for an external source of funding. It was deemed somewhat unrealistic to assume that all borrowers will prepay their mortgage down to £1 and redraw the full amount all at the same time. Rather, it was assumed that borrowers will prepay and redraw at random, for the most part (*although refer to section on Redraws and Payment Holidays, in Loss Severity, above*). The seller can regulate such random behaviour to some extent with the commitment fee. For the majority of flexible mortgages in the pool, the issuer has the right to increase the commitment fee and decrease the threshold, thereby creating a disincentive to prepaying, if necessary. The overall level of coverage for potential redraws required by Fitch varies depending on whether or not the lender has the ability to modify the terms of the commitment fee.

The redraw facility serves as a backstop to the seller's control mechanism. Therefore, the size of the facility need only cover a portion of total potential redraws. A cash flow model was used to determine the potential exposure to redraws throughout the life of the transaction. The two key inputs to the model were prepayment speed and redemptions as a percentage of prepayments. The model showed that throughout the life of the transaction, given the aforementioned methodology, the maximum exposure would be GBP [58] million.

Set Off Risk

The rights of borrowers to redraw and take payment holidays (as described in the section on Flexible Mortgages above) are met initially by BM and FA (where applicable), and then sold to the issuer on the next interest payment date insofar as there are available funds within the redraw facility and to the extent of the outstanding balance of the class A notes. To the extent that the issuer is unable to purchase further redraws, the obligation to fund them rests with BM or FA. Should this obligation not be met, borrowers may make damages claims that they may subsequently be able to set off against their obligations to the issuer. Fitch believes that this risk is minimal with respect to the senior notes, and covered adequately by the credit support within the structure of the transaction with respect to the junior tranches.

Priority of Payments

On each monthly payment date, the priority of payments will be as follows:

1. Trustee fees and associated cost.
2. Amounts due to the paying agent and agent bank.
3. Expenses of the issuer.
4. Servicing fees.
5. Amounts payable to the swap counterparty, fees and interest on the redraw facility, and interest on class A (*pro rata and pari passu*).
6. Subject to a class M note trigger event not occurring, interest on class M.
7. Subject to a class B note trigger event not occurring, interest on class B.
8. Credit the reserve fund up to its required amount.
9. To pay for the purchase by the issuer of redraws.
10. To repay all principal amounts outstanding under the redraw facility.
11. To fund the purchase by the issuer of further advances up to the maximum amount.
12. During the substitution period only, to fund the purchase by the issuer of further mortgages (subject to the previously mentioned constraints).
13. To allocate any principal amounts received in the form of redemption, prepayment, enforcement proceeds, recoveries and insurance proceeds (after principal loss is realised and principal deficiency recorded) in redeeming the notes.
14. If a class M note trigger event has occurred, to pay class M interest.

15. If a class B note trigger event has occurred, to pay class B interest.
16. To credit the base reserve up to its required amount of [0.30]% of aggregate current principal balances (drawn and undrawn) of unhedged base rate linked mortgages.
17. To fund the purchase of hedges required to a rate at least equal to the threshold rate in respect of prefunded, further or substitute mortgages, or further advances, purchased on such interest payment date.
18. To credit the discount reserve in order to cover expected deficits arising from discounts on further or substitute mortgages, or further advances, purchased on such interest payment date.
19. To make any termination payments to the swap counterparty.

Provided that there is no principal deficiency and no event of default:

20. To pay amounts repayable to the servicer.
21. To pay interest on the start-up loan.
22. To pay principal on the start-up loan.
23. To pay deferred consideration to Arianty, BM, and FA.
24. To make dividend payments to shareholders of the issuer.

Credit Enhancement

The class M and B notes are subordinate to class A, thereby creating [8]% in credit enhancement for the senior notes. The reserve fund also provides credit enhancement for classes A, M, and B. The reserve fund is sized at [1.5]% of the initial principal balance of the Notes. Fitch believes that these levels of credit enhancement are sufficient to support the expected ratings.

Reserve Fund, Hedge Reserve, Base Rate Reserve and Discount Reserve

The issuer is required to use funds from the reserve fund and the hedge, base rate and discount reserves to pay certain liabilities to the noteholders if income received from mortgage loans is insufficient to cover such liabilities.

These reserves have all been funded by a portion of the proceeds from the start-up loan. Amounts credited to the reserve fund will be available to meet income deficiencies, including interest shortfalls on the class A, M and B notes.

Representations and Warranties

Representations and warranties will be given by the originators in relation to the pool of mortgages. No search of title will be conducted by the issuer or the trustee, rather they will rely on the above mentioned representations and warranties. If there is an unremediable breach of any of the representations or warranties, the relevant seller will be required to repurchase the loan(s) in question.

Specifically, the representations and warranties include the following:

- Each mortgage constitutes a first ranking legal mortgage, which is a valid and binding obligation of the borrower, enforceable under its terms.
- Each loan has been underwritten according to the originators lending criteria outlined in the offering circular. This includes proper investigation and search of the relevant properties.
- No loan has a final maturity greater than two years prior to the final maturity of the notes.
- All loans were originated by BM or FA.
- All loans are either base rate linked, LIBOR-linked, standard variable rate or fixed rate mortgages.

Legal Structure

First Flexible 4 is a public company incorporated under the laws of England and Wales. On the closing date, First Flexible 4 will acquire the collateral from Arianty. As security for the payments of all moneys payable with respect to the notes, First Flexible 4 will enter into a deed of charge, creating the security in favour of the trustee. The security includes first mortgages and first fixed charges in favour of the trustee on all the issuer's rights, claims, title, benefit, and interest in and to the underlying collateral.

The transaction's structure was designed to ensure that a seller insolvency would not interrupt the timely payments of principal and interest to investors. The loan sellers assign their right, title, and interest in and to the mortgages to the trustee. There is no recourse to the loan sellers as the sellers of the mortgages, such that the transfer is treated as a true sale and the mortgages were removed from the loan sellers' balance sheets.

Origination and Servicing

BM is part of The Britannic Group, a leading UK financial services conglomerate specialising in asset management, assurance and retirement solutions. Since its incorporation in 1986, BM, formerly First Active Financial plc, has focused on lending to a specific niche of the UK mortgage market. BM is a pioneer in the flexible and buy-to-let mortgage markets.

Mortgages are originated via direct distribution centres and indirectly through a network of brokers. BM also increasingly uses the internet to source originations. The underwriters at BM have experience mostly from high street lenders. New hires follow a specific training/mentoring program after which they are gradually given increasing underwriting limits. Although the underwriters follow the underwriting guidelines established by BM, they are allowed certain “discretion points” based on their seniority/experience. This results in an application to completion rate of approximately 60%.

BM have an experienced mortgage servicing operation. The systems developed are user-friendly and tailored specifically for securitisation purposes.

BM’s servicing and origination operations are co-located in Epsom. Its servicing operations have been upgraded by hiring a team from a US financial services operations centre to increase work flow and telephone call efficiency. The arrears management team is a separate group within servicing. Most mortgage payments are made via direct debit on the last business day of the month. If the direct debit fails, a notice goes to the borrower on the same day. If the payment does not clear on the second attempt it is automatically referred to the arrears department, which makes a phone call to the borrower. If the situation progresses to where two payments have been missed, legal action is considered and after three months of being in arrears, an order for possession of the property is executed.

Fitch has determined that BM and FA are both capable origination and servicing operations.

Surveillance

Fitch will maintain surveillance of this transaction by reviewing ongoing performance reports, available on Bloomberg at “FI” <GO> and on website www.fitchratings.com. Queries regarding surveillance information should be directed to Omar Mirza on telephone number 020 7417 6266 or by e-mail at *sf_surveillance@fitchratings.com.*

Appendix I: Rating Methodology

■ Model Approach

To determine loss coverage for RMBS, Fitch's default model employs a loan-by-loan review, examining several loan-, borrower-, lender- and property-specific factors that most influence default probability and loss severity. Fitch's base default probability analysis focuses primarily on the borrower's income multiple, in conjunction with the loan's LTV. These expected default rates are then adjusted further by loan, borrower, lender and property attributes. A large component of Fitch's loss severity analysis is market value trends. Fitch's market value assumptions focus on historical regional volatility and sustainable growth. Market value projections are then adjusted by loan and property attributes.

Default Probability Adjustments

Underwriting and Servicing Quality: When applying the default probability matrix, Fitch also considers a lender's underwriting and servicing guidelines. Fitch's views will be formed following a due diligence visit, where the lender's criteria and procedures regarding borrower income, LTV, borrower's past credit performance and many other factors will be considered. Fitch's review and analysis of the originator determines whether it decreases base default rates by up to 25% or increases them by up to 250%.

Investment Properties: Fitch's methodology in evaluating the default probability of a Buy-to-let (BTL) portfolio is to use the UK residential default model, but with the following additional assumptions:

- For the base probability of default, BTL loans are assigned an affordability class based on underwriting criteria related to the minimum interest cover requirement. Generally speaking, Fitch will assign a high affordability class (meaning less affordable and thus a higher base probability of default) unless rental yields are estimated to exceed 150% of the mortgage payment, including principal, and are tested at a stressed interest rate.
- A loan-by-loan increase in base default probabilities by 25% for the fact that the properties are non-owner occupied.
- Increase in the underwriting quality factor to account for lack of experience in BTL. This factor also incorporates originator-specific issues related to underwriting criteria, historical experience as well as servicing capabilities.

Repayment Types: The most common repayment types in the UK market are repayment and interest-only mortgages. Interest-only mortgages are usually linked to some form of investment vehicle: either an endowment policy, a pension or Individual Savings Account (ISA) which are designed to repay the loan principal on maturity. The following factors should be noted:

- Repayment mortgages incur no default probability adjustment.
- Interest-only mortgages are susceptible to the payment shock associated with a 'balloon' repayment for the entire principal at maturity. The borrower may be able to remortgage and thereby pay off his existing mortgage; however if his circumstances have changed this may not be possible. The further off the maturity date is, the more there is capacity for the borrower's circumstances to change. For this reason, Fitch applies an increased default factor to interest only loans of between 1-1.33 depending upon the length of time to maturity.

Loan Purpose: Fitch does not penalise mortgage loans advanced to purchase a home or those advanced to refinance existing mortgage loans, nor loans to release equity for the purpose of home improvements. However, Fitch views mortgage loans advanced to release equity in the home (equity refinance mortgages) in order to consolidate other existing debts (such as credit cards) as more risky by their nature. For this reason, Fitch applies an increased default factor of 1.1-1.25 depending on underwriting criteria for such loans.

Mortgages in Arrears: When rating a portfolio combining current and arrears mortgages, Fitch increases base default rates for mortgages in arrears up to 90 days by factors between 1.25 and 1.75. For mortgages that are in arrears for more than than 90 days, Fitch assumes a 100% default probability.

Second Homes: While information about mortgage performance for second homes is limited, Fitch believes that second homes are considerably more susceptible to default. A financially distressed borrower is more likely to default on a second home than on his primary residence. Accordingly, Fitch increases base default by a factor of 1.1-1.25.

Right to Buy: Council tenants have the opportunity to purchase their own homes through the UK government's Right to Buy scheme. Available information suggests that there is a higher propensity to default. For this reason Fitch applies and increases default probability factor of between 1.1-1.25.

Product Type: Most UK RMBS issues are primarily backed by variable rate mortgages. While variable-rate mortgages can experience payment shock due to underlying index volatility, this risk is usually gradual with ½-1% interest rate rises. Other mortgage types commonly available include initially fixed-rate mortgages and capped-rate mortgages which reset to variable rate after a limited period. Although these loans may be more susceptible to payment shocks after the reset date (if rates have risen substantially during the fixed- or capped- rate period) Fitch believes this does not warrant a supplementary default factor. Other product types will be evaluated individually.

Loss Severity

Fitch's UK default model quantifies loss severity (or, conversely, recovery value) by focusing on several factors, including market value declines, foreclosure and carrying costs, and LTV.

Market Value Declines: Fitch's MVD methodology focuses on three key factors: volatility of observed prices from the long-term trend; historical levels of stress experienced in the housing market of each region; and the current position of the index relative to the long-term trend.

For example, the MVDs for East Anglia, London and the South East are highest, reflecting high historical volatility and current prices well above the long-term trend line. The MVD for Scotland is lowest, reflecting low historical volatility and current prices slightly below the long-term trend line.

Indexing of Property Valuation: Fitch's model uses a conservative index to adjust original property values depending on the year of valuation. The index is based on information obtained from sources in the mortgage industry and considers both the year of valuation and the region in which the property is located. Where there has been capital appreciation this is a mitigating factor in the calculation of loss severity but will be offset by higher MVDs assigned to regions that have seen above average price appreciation.

High- and Low-Value Properties: Homes with relatively high or relatively low market values are generally subject to higher MVDs in a deteriorating market than homes with average market values due to limited demand for such properties. Imprecise pricing information, caused by the lack of comparable benchmark homes in the case of high-value properties, also influences the amount of price volatility during a market downturn. The market value thresholds are increased periodically to reflect the increase in housing prices. Adjustments for high- and low-value properties are split between London and the rest of the country due to higher prices in London, and the differential between what would constitute a high- or low-value property.

Mortgage Indemnity Guarantee (MIG) Policies: Many lenders require borrowers to pay for MIG for that portion of their mortgage loan which exceeds a certain LTV level (usually 75%). In case of default by the borrower, the lender will be able to recover any loss on the portion of the loan in excess of that LTV limit (subject to any policy deductions) from the MIG provider. Fitch will give credit for MIG on a case-by-case basis. Fitch will review the MIG policies to determine the extent of coverage and payment terms and to determine whether there are any exclusion clauses which might lead to non-payment of claims by the insurer. The insurer's rating is also taken into consideration when determining the amount of credit to be given for MIG.

Geographic Concentration: Fitch also assumes that a mortgage portfolio is generally broadly diversified in geographical terms. A particular region might be more sensitive to economic downturns and/or other negative developments in the property and mortgages market than others. If a portfolio has significant regional concentrations, Fitch will make adjustments on a case-by-case basis. As a general rule, for pools with high concentrations in specific regions, credit enhancement necessary for a particular rating level will be higher than for geographically diversified portfolios.

Foreclosure and Carrying Costs: When calculating recovery value, Fitch's model reduces the property valuation by foreclosure costs and the cost to the administrator of "carrying" the loan from delinquency through to default. Fitch assumes foreclosure costs amount to 5% of the sale price at the time of foreclosure. This estimate is based on actual cost data supplied to Fitch, and may be adjusted as cost structures change in the industry and jurisdiction.

To calculate carrying costs, Fitch assumes the borrower does not pay interest for 18 months in the case of a residential property and 12 month in the case of an investment property. The interest rate used reflects the need to continue to service the notes during the period that the defaulted loans are not generating any revenue. The 18- and 12- month time frames are based on worst-case estimates obtained from U.K. mortgage lenders.