

RMBS / UK
Presale Report

Homeloans (No. 4) PLC

Expected Ratings*

Class	Amount GBP (million)	Final maturity	Rating	CE (%)
A	198.0	2019	AAA	11.9
B	16.5	2028	A	4.4
C	5.5	2028	BBB	1.9

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*Preliminary ratings do not reflect final ratings and are based on information provided as of 28 February 2002.

■ Summary

This GBP220 million transaction is a securitisation of residential mortgages originated in the UK. Fitch Ratings ("Fitch") has assigned expected ratings to the notes to be issued by Homeloans (No. 4) plc (the "issuer") as indicated at left.

The expected ratings are based on the quality of the collateral, available credit enhancement, the servicing capabilities of Paragon Finance PLC ("PFPLC") and Global Home Loans Limited ("GHLL") and the sound legal structure of the transaction. Credit enhancement for the class A notes totals 11.9%, provided by the subordination of the class B notes (7.5%) and the class C notes (2.5%), and, if required on the final payment date, a reserve fund (described as the "First Loss Fund" in the documentation) of 1.9%. Apart from this special case, the fund will be available only as a liquidity reserve until the class A notes are fully amortised, at which point it will become available to provide credit support to the class B and C notes.

The mortgages were originated for the most part by National Home Loans and Société Générale in the late 1980s. Origination and underwriting procedures and criteria during this period are generally recognised as being less robust than those that exist today.

The Paragon Group of Companies ("the Group") was formed in the wake of the collapse and subsequent rescue of National Home Loans ("NHL"), a centralised mortgage lender which advanced home loans in the late 1980s and early 1990s. With the sharp hike in interest rates, economic recession and a concurrent drop in house prices in the early 1990s, NHL suffered rising arrears and increasing losses on its mortgage loan book. A withdrawal of local authority deposits from its subsidiary, National Mortgage Bank, threatened NHL with insolvency. Following intervention by the Bank of England, NHL was salvaged and evolved into the Paragon Group of Companies. In 1994, the Group began to extend new credit under tightened mortgage underwriting policies and procedures and in 1996, adopted the "Paragon" brand. The Group does not lend to the so-called sub-prime sector, and lending decisions are based on a credit analysis model in line with other prime lenders, albeit one specialising in niche non-conforming products, such as buy-to-let mortgages.

Société Générale was one of a number of foreign lenders which entered the booming UK residential mortgage loan market in the late 1980s. The Group purchased the Société Générale mortgage loan portfolio from the French bank in 1997.

■ Credit Committee Highlights

- The First Loss Fund is not available to pay down losses while any class A notes are outstanding (except if required on the final payment date). Conversely, this ensures the fund is available in its entirety to provide liquidity support during this period.
- Although originally underwritten as a prime portfolio in the 1980s, the remainder of the NHL portfolio consists of a high proportion of borrowers who struggle with their mortgage payments - 40.4% of the portfolio consists of loans over three months in arrears. Many of these loans are or have been subject to short-term reduced payment arrangements, whereby an amount less than the scheduled payment may be acceptable for a period.
- The portfolio is highly seasoned (152 months, on a weighted average basis), and the weighted average current loan-to-value ratio (WA CLTV) after indexation is 53.4%. Fitch awards 50% credit to upwards-indexation, and 100% to downwards-indexation of property values, based on the Nationwide property index.
- GBP34 million worth of pre-closing interest arrears is available as revenue as, and to the extent, it is recovered. This amount depends on the propensity of borrowers to reduce their arrears balances, as well as the ability to recover such amounts in the foreclosure process.
- The Group has been taken to court on one occasion by certain NHL borrowers who dispute the legitimacy of increased interest rates charged as a result of the portfolio's overall poor arrears performance. Fitch continues to monitor this case closely, and notes that the Court of Appeal recently ruled in favour of the Group.

■ Credit Structure

The financial structure of the transaction is designed to provide differing degrees of credit enhancement to the three note tranches. The class A notes are protected firstly, by any excess spread; secondly, by the subordination of the two junior tranches; and, on the final payment date **only** - if required - by the First Loss Fund. The class B and C tranches are supported firstly, by any excess spread; secondly, in the case of the class B notes only, by the subordination of the class C tranche and thirdly, by the First Loss Fund, which is available on every payment date following the redemption of the class A notes as well as on the final payment date. The issuer also has beneficial interest in GBP34 million

worth of pre-closing interest arrears, which, as and to the extent that they are recovered, will act as additional revenue receipts.

As in a conventional UK RMBS structure, any residual excess spread is used to replenish the First Loss Fund to its required amount and cure any principal deficiencies on every payment date before the remainder returns to the originator. No earlier than June 2007, this required amount will be the lesser of GBP4.18 million and 3.8% of the outstanding balance of the loans, subject to various performance triggers and conditions described below.

Due to the restrictions on its application, the First Loss Fund is essentially a liquidity facility for as long as the class A notes are outstanding. Should this fund be insufficient to prevent an interest shortfall arising on any class of notes, principal receipts can be reapplied to cover this deficit, though in the case of Class B and C note interest, only prior to any deferral of Class B and C note interest in the priority of payments as described below.

To the extent that, in any payment period, losses are realised on the loans and/or principal receipts are to be used to meet senior interest shortfalls, the PDL is debited by that amount. Such a debit balance is reduced (wherever possible to zero) at its position in the revenue priority of payments using applicable revenue, which is reapplied to the principal priority of payments. Should a PDL debit balance fail to be extinguished at inception, it is carried forward to subsequent payment dates until it can be fully cleared.

For a diagram of the structure, please see Transaction Structure on page 10.

Revenue Priority of Payments

Amounts standing to the credit of the revenue ledger will on each payment date be applied to the revenue priority of payments. This includes all interest payments received from borrowers within a payment period (*including any arrears interest accrued prior to closing, whether paid voluntarily or recovered via foreclosure*), interest earned on short-term investments, and any amounts standing to the credit of the First Loss Fund.

On each quarterly interest payment date, such amounts will be applied as follows:

1. Trustee and servicing fees.
2. *Pro rata*, amounts due and payable (i) under the swap agreement and (ii) as interest to the class A noteholders.
3. Interest due and payable on the class B notes.
4. Interest due and payable on the class C notes.

Key Information

Provisional pool characteristics

Total Amount: GBP236 million
 Number of loans: 6,150
 WA Current LTV(indexed by Fitch): 53.4%
 WA Original LTV: 69.3%
 WA Seasoning: 152 months

Structure

Originators: National Home Loans and Société Générale
 Mortgage Administrator: Paragon Finance PLC
 Standby Mortgage Administrator: Global Home Loans Limited
 Transaction Account Bank: National Westminster Bank plc rated 'AA-/F1+' by Fitch Ratings

5. Amounts of VAT to be paid in respect of the issuer, if any.
6. Amounts required to replenish the First Loss Fund.
7. Amounts applied in extinguishing a debit balance on the principal deficiency ledger ('PDL') recorded in respect of realised losses.
8. Other subordinated amounts, including a provision for a reserve to fund any purchase of caps or other hedging instruments in the next period.

Should the debit balance recorded on the PDL exceed the outstanding balance of class C notes, items (4) and (5) will be relegated below item (7). This ensures that while there is a PDL debit balance registered against the class B notes, that neither the First Loss Fund nor any principal receipts will be available to pay interest on class C notes. Furthermore, were the debit balance recorded on the PDL to exceed the aggregate outstanding balance of class C and B notes, items (3), (4) and (5) would be subordinated behind item (7). Likewise, this ensures that while there is a PDL debit balance corresponding to the class A notes, that neither the First Loss Fund nor any principal receipts will be available to pay interest on class C or B notes. Instead, such revenue will be applied in reducing the PDL debit balance until such threshold corresponding to the payment of junior interest. Once the class A notes have been fully repaid, item (6) will be relegated below item (7), so that the First Loss Fund will become available to cure any principal deficiencies that may subsequently arise.

Principal Redemption

Mandatory: In addition to the loss provisioning mechanism described above, and other than in respect of a usage of principal to fund a further advance or an interest shortfall, the notes are retired in accordance with amortisation of the loans on a pass-through basis.

With the exception of further advances to borrowers, all principal payments received from borrowers during a single payment period (including scheduled repayments, prepayments and previously delinquent principal) together with sale proceeds from defaulted loans are held in the transaction account at National Westminster Bank plc (along with amounts standing to the credit of the revenue ledger). For the duration of the payment period, such amounts are used to purchase investments whose eligibility depends on having both or either of a suitable long-term rating (AAA) and short-term rating (F1), as well as a maturity before the next payment date.

On the subsequent payment date, applicable principal receipts are passed through to noteholders. Amortisation of note principal will initially occur in a sequential fashion, such that junior noteholders shall not receive back any principal amounts while there are more senior notes outstanding. However, amortisation will take place *pro rata* according to the outstanding balances of the three tranches, if the following circumstances apply:

- The balance of junior notes as a proportion of the total outstanding balance of notes exceeds two and a half times that at closing,
- it is after June 2007,
- there is no debit balance on the PDL,
- the balance of loans in arrears for over three months is less than 20% of the then current balance (that is reduced from the current percentage of 40.42%), and
- the aggregate outstanding balance of class B and C notes is greater than 4.7% of the initial principal balance of the notes.

Optional: At the option of the cash/bond administrator, on behalf of the issuer, it is possible to redeem all of the class A, B and C notes at their respective outstanding principal amounts plus accrued interest, but only in any of the following circumstances:

- on or after the interest payment date in June 2005,
- if the then current outstanding principal amount is less than 20% of the initial principal balance of the notes,

- if the issuer is required to make any withholding tax deductions.

Fitch's ratings do not address the possible exercising of these call options held by the issuer.

Final: To the extent not previously paid down, the class A notes are due to be redeemed in full in March 2019, and the Class B and C notes are due to be redeemed in full in Sept 2028.

Interest Rate Risk

While none of the loans will have a fixed rate of interest at closing, it is conceivable that PFPLC will agree to convert some variable loans into fixed or capped rate loans, for a certain period of time, if requested by the borrower. In such a situation, the issuer will hedge the resultant interest rate risk by entering into appropriate hedging arrangements.

Since interest payment dates tend to be set by convention, and as a result, may not coincide with mortgage interest reset dates, some loans contain a residue of interest rate basis risk. In this deal, there is an interval of 15 days between the reset date of three-month mortgage LIBOR and the interest payment date (when three-month note LIBOR is set). If three-month LIBOR increases during this period, excess spread will be duly compressed for the ensuing period.

82.98% of the portfolio is charged interest in relation to PFPLC's standard variable rate ('SVR'). There is no guarantee that this basis will not diverge in relation to three-month LIBOR, thus potentially compressing the weighted average margin on the loans. While Fitch acknowledges PFPLC's pledge to maintain a weighted average contractual margin over three-month LIBOR on the reference portfolio as a whole of at least 4.5%, Fitch has placed no reliance upon this mechanism in its analysis.

Furthermore, since many of these loans are or will be subject to reduced payment arrangements – whereby an amount lower than the contractual payment may be accepted – Fitch has not given full credit to the contractual interest rate margins. Instead, Fitch has used 24 months of data regarding payments due versus actually received on a loan-by-loan basis to derive an average margin received, bearing in mind that PFPLC allocate receipts to interest (exclusive of pre-closing arrears) prior to principal. The weighted average margin received has been further compressed to reflect the assumption that higher margin loans will have prepaid before lower margin loans.

Loans that are not related to PFPLC's SVR are linked either to (i) a national rate of interest declared by the Secretary of State, in respect of 1.44% of loans originated by local authorities and purchased by PFPLC, or (ii) three-month LIBOR, in respect of 15.58% of the reference portfolio.

First Loss Fund and Excess Spread

The issuer is initially endowed with a First Loss Fund of GBP4.18 million (1.9% of the initial note balance), entirely funded from a subordinated loan advanced by PFPLC.

The balance standing to the credit of the First Loss Fund forms part of available revenue funds to be applied on each interest payment date to the revenue priority of payments. This fund has been sized to provide sufficient credit enhancement to the class B and C tranches, and, in an extremely stressful situation only, to the class A tranche. This restriction is designed to allow the fund to be used as liquidity during the early years of the deal, and to be available to provision also for losses only in the later years.

The disadvantage of such a measure is that if substantial losses are incurred early in the deal – while class A notes remain outstanding – the issuer would be unable to accelerate principal repayments by depleting the First Loss Fund, and as a result, would encounter 'negative carry' (due to the difference between the short-term investment rate and the coupon on the senior notes). Fitch has built this factor into its cash flow modelling.

On or after June 2007, provided that

- there is no debit balance on the PDL, and
- the balance of loans in arrears for over three months is less than 6% of the then current balance,

the required amount will be the lesser of GBP4.18 million, 3.8% of the then current balance of the loans, subject to a floor which is the greater of GBP1 million and two times the current balance of the largest mortgage in the reference portfolio.

Whenever the reserve fund is not at its required amount, it is replenished using any available income at its position in the revenue priority of payments.

Unlike the First Loss Fund, excess spread is a source of credit support (and liquidity) for all tranches of notes on every payment date, 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 could be least available when it is most needed. It is eroded by delinquencies and defaulted loans, an effect that is compounded if higher margin loans are

affected. Should high margin loans repay more quickly than those with lower margins (whether as a consequence of divergent rates of prepayment or shorter tenors), then there is further compression of excess spread. Furthermore, high rates of prepayment for the portfolio as a whole would squeeze the gross amount of excess spread available over the course of the transaction.

In order to take account of these factors in its cash flow modelling, Fitch has applied its performance assumptions (derived from the collateral model) in conjunction with stressed rates of prepayment of loans in order to stress margins received over time.

■ Collateral Credit Analysis

The provisional pool analysed consists of residential mortgage loans with a total outstanding balance of approximately GBP236 million (as of 28 February 2002). Below are highlighted the distinguishing characteristics of the portfolio, with commentary on any special considerations.

Arrears Loans

40.42% of the reference portfolio is in arrears of over three months. This high figure reflects not only the financial problems incurred by these borrowers during the recession of the early 1990s, but also the policy of PFPLC in administering arrears cases.

Instead of inevitably foreclosing on a borrower who fails to meet successive contractual payments, PFPLC may – when it is deemed economically viable – choose to obtain a suspended possession order in parallel with a payment arrangement with the borrower. In this way, the borrower is able to continue to live in the property for the next three months, provided the borrower complies with an agreed reduced payment (with the contractual deficit rolled forward as accrued arrears, upon which balance further interest is charged).

Such an arrangement is reviewed at the end of the three months, normally with a view to increasing the reduced payment; in any case, the amount proposed is based on a calculation of the security position of PFPLC taking into account the net present value of future interest receipts, the circumstances of the borrower, and the short-term outlook for house prices in the relevant area. If the calculation suggests a higher reduced payment is required, PFPLC will communicate this to the borrower; failure to meet this will ordinarily result in a re-commencement of legal proceedings.

In addition to the above factors, it has been the policy of PFPLC to manage the SVR in response to the dynamics of the portfolio as a whole. In this way,

already delinquent borrowers may have found themselves facing higher contractual interest payments, which may exacerbate the growth of their arrears balance.

The existence of such loans in the portfolio is both a strength and weakness for the deal. Fitch views loans over three months in arrears as highly risky, and accordingly applies a 100% probability of default regardless of rating scenario. However, as owner of the pre-closing arrears, the issuer stands to benefit from any recovery of these positions, either by way of an improvement in borrower circumstances or a greater entitlement to any sales proceeds. Such amounts will pass down the revenue waterfall as, and to the extent, they become available. Fitch has modelled the recovery of interest arrears on a loan by loan basis in its default model.

Shared Ownership Mortgages

This type of mortgage, representing only 0.34% of the reference portfolio, is secured on a share in a property, the remaining equity of which is retained by a landlord, to whom the borrower pays rent.

There are several methods open to the administrator were it to consider foreclosing on a loan, depending on the particular type of product, the terms of the lease, and the preferences of any landlord. In some instances, the issuer may be required to pay to the landlord for any delinquent rent, which ought to represent at worst only a minor increase to loss severity (although Fitch notes that landlords are not obliged to report rent arrears to the issuer). It is possible too that under certain circumstances the landlord might obstruct a free sale of the shared estate, preferring instead to nominate a purchaser.

Right to Buy

Loans granted for the purpose of assisting a council tenant with a purchase of the property are believed to carry an additional risk of default, based on anecdotal evidence, and represent 3.19% of the reference portfolio.

Repayment Type

Borrowers with repayment mortgages account for 46.14% of the portfolio. The remainder of the pool is composed of interest-only mortgages, which, regardless of the existence of any repayment vehicles, Fitch believes are more susceptible to a default at maturity caused by the borrower experiencing a payment shock and being unable to refinance the loan. This reasoning is unaffected by the existence of any repayment vehicle.

Conversion

Although there are currently no fixed rate or capped loans in the pool, subject to certain conditions, borrowers may have requests to convert certain aspects of their mortgages approved. In the event that permission be granted to change a variable rate loan into a fixed or capped rate loan, the issuer would have to enter into appropriate hedging arrangements.

Further Advances

Discretionary further advances may be agreed and advanced to borrowers in the pool by the administrator (acting on behalf of the issuer) using principal receipts or recoveries, provided that:

- there was no debit balance on the PDL as at the previous interest payment date,
- the aggregate of (i) the issuer's maximum potential obligation – at closing – to fund mandatory further advances, and (ii) the balance of discretionary further advances made or being considered, is no greater than GBP7 million,
- the reserve fund is at its required amount,
- in respect of discretionary further advances, the borrower is not in breach of the mortgage terms and conditions, and
- the weighted average current loan-to-value of the portfolio would not exceed its value at closing by more than 1%.

■ Origination and Servicing

Fitch visited the Group, met with senior staff and ascertained the origination process of NHL as well as conducting a review of the servicing facilities of PFPLC.

Origination

At the outset of the 1980s, about 80% of lending was controlled by a small number of high street building societies. However, this proportion dropped to around 60% following the entry of 'centralised lenders' such as NHL (as well as some banks) into the mortgage market. These new entrants ostensibly competed for the same borrowers as the building societies and as a result, standards across the industry were relaxed. In common with some other lenders at the time, NHL underwriters did apply some discretion towards satisfied or minor CCJs (but not previous bankruptcies or defaults). In addition, certain products stand out as entailing excessive risk; for instance, the 'deferred interest' loan allowed borrowers to postpone interest payments during times of stress – sometimes for up to five years – and 'catch up' later.

While, in retrospect, few would contest that the underwriting standards adopted by NHL were less stringent than those on the high street, the major differences lay not in the published criteria (regarding LTV limits, etc), but rather in that the ancillary information checks were often substandard. Since applications were processed externally, mainly by life insurance companies (known as 'life offices'), data verification was often constrained by the third-party's administrative inadequacies. For example, in respect of loans with an LTV of under 75%, employed borrowers were exempt from having to certify not only their income, but also the performance of any outstanding loans, which meant that arrears may have been unwittingly re-mortgaged. Credit check profiles captured only 'black' data (such as the CCJ account) rather than the broader 'white' data provided nowadays. At worst, checks performed amounted to little more than a verification of the existence of the borrower.

NHL undoubtedly placed great weight on its equity position, perhaps at the expense of other important factors. However, one could argue that the deficiencies alluded to in the previous paragraph were partly compensated for by the rigour applied on the suitability of the security. Thorough valuation procedures were followed, and rather than relying on 'drive-by' valuations, NHL required that a full valuation was undertaken, even for re-mortgages. For properties valued at over GBP120,000, reasonability tests were performed; moreover, valuation reports were considered to have expired after only a few months.

Servicing

Fitch has visited Paragon's collections department and spoken with senior management and collections agents, including the executive director of operations responsible for the group-wide collections team. Fitch believes that the staffing, technology and procedures are adequate for the administration of delinquent mortgages. The following summarises the highlights from the agency's visit.

PFPLC employs a small team of highly-experienced collection agents assigned specifically to service the portfolio. The portfolio contains a large rump of borrowers who have been in arrears for a considerable period and are familiar with PFPLC's personnel and collections approach. Accordingly, the borrowers know the servicer's rules and the collection agents are better able to predict and preempt their behaviour.

With the experience gained during the aftermath of the early 1990s housing recession, PFPLC recognises that relationship-management is the

essential component of the collections process. Although the company employs a sophisticated system (“CACS”) which facilitates user-friendly, diary-oriented case-tracking and call-routing, the collection agents adopt a personal approach (the power-dialling technology is not engaged for this portfolio). Empathy and assertiveness are the tools used in preference to aggressive tactics.

A small number of borrowers in arrears may be offered payment arrangements determined by PFPLC’s two payment matrices. The first uses a cost-of-funding algorithm to ascertain the minimum payment that is acceptable to the company; the second features a house-price-inflation algorithm that uses house-price movements, predicted by the company’s in-house surveyors, to further ascertain suitability of the payment arrangement. During times of house price appreciation, the borrower need only meet the minimum payment determined by the second matrix. Provided that the reduced payment is met, the company will suspend any ongoing litigation. However, the payment is regularly reviewed to ensure that the company’s minimum threshold is still being met. These arrangements are short-term and are not used as a mechanism to extend the term of the mortgages. Suitability of the arrangements is assessed on a borrower-by-borrower basis as they are intended to give the borrower the opportunity to resolve short-term financial difficulties rather than to provide a long-term solution.

The company’s in-house regional surveyors are allocated portfolios of specific local cases to monitor proactively for movements in value in order to make the necessary inputs to the arrangement matrix. The surveyors are not compensated based upon performance, so their valuations are viewed as being entirely independent. The collection agents are however rewarded based upon collections’ performance, with performance-related bonuses of up to 50% of salary. The awards are based upon several measures and are made on both a team and individual basis.

PFPLC has its own in-house legal firm, branded as “RD Shelton”, which handles litigation and foreclosure proceedings. RD Shelton links into the CACS system ensuring that the collections agents can access fully up-to-date case status, thereby harmonising the collection and litigation efforts. Fitch views this arrangement favourably as it ensures a highly-controlled and speedy reaction to rapidly changing borrower and property circumstances.

■ Representations and Warranties

The mortgage sale agreement contains representations and warranties given by PFPLC 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 such representations and warranties. If there is an unremediable breach of any of the representations or warranties, PFPLC 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.
- No lien or right of set-off exists between the borrower and the originator.
- Each loan has been underwritten according to the originator’s lending criteria outlined in the offering circular. This includes proper investigation and search of the relevant properties.
- Prior to granting the loan, a property valuation was conducted by an independent valuer from the panel of valuers appointed by the originator.
- Each loan governed by the Consumer Credit Act 1974 meets the requirements of the Act in full.
- At its date of completion, each property was insured under a buildings policy or a block buildings policy.
- No loan has a final maturity greater than two years prior to the final maturity of the class C notes.

■ Performance Analytics

Fitch will monitor the transaction on a regular basis and as warranted by events. Fitch’s structured finance surveillance team ensures that the assigned ratings remain, in Fitch’s view, an appropriate reflection of the issued notes’ credit risk.

Details of the transaction’s performance are available to subscribers at www.fitchresearch.com. Further information on this service is accessible at www.fitchratings.com.

Please call the Fitch analysts mentioned on the first page of this report for any queries regarding the initial analysis or the ongoing surveillance.

Appendix 1 – 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 1.1-1.33 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 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. These loans, however, 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.

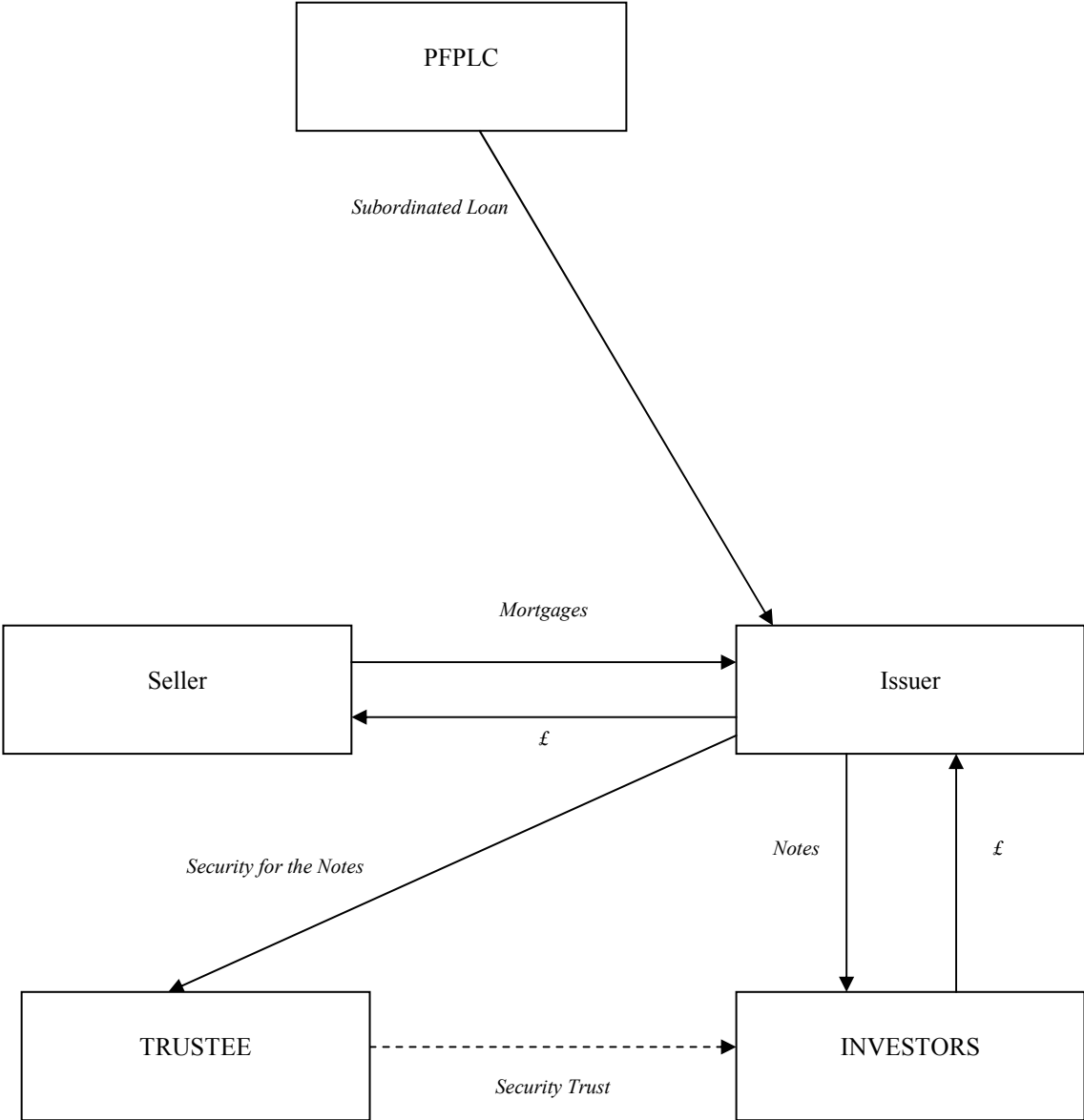
Mortgage Indemnity Guarantee (MIG) Policies: Many lenders require borrowers to pay for MIG for that portion of their mortgage loan which exceeds a certain LTV level (usually 75%). In case of default by the borrower, the lender will be able to recover any loss on the portion of the loan in excess of that 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 months 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 UK mortgage lenders.

■ Appendix 2 - Transaction Diagram



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