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Europe

UK Buy-to-Let RMBS

Cheap for Prime Quality but Mind Back-end Risks

- **Negligible Credit Risk in Seniors**— Senior-most tranches of all the BTL deals we examined experience no credit losses even in our fairly conservative stress scenario.
- **Cheap to Comparable Shorter WAL Assets** — Short 3–6YR WAL senior BTL prices roughly 48–98bp wider to comparable 5YR UK prime seniors at EURIBOR +52bp. Longer 10–14YR WAL PARGN bonds offer EURIBOR +120–164bp in our analysis.
- **Positive Collateral and Securitization Technicals** — At the same time as the rental market is growing, a lack of securitization has led to low new issue bond supply.
- **Efficient Recovery and Servicing Process** — BTL recovery processes are more efficient than those of owner-occupied mortgages because of the "Receiver of Rent" strategy and no moral hazard concerns in disposing of non-performing properties.
- **New Budget Could Tilt Positive Demographics** — Easier credit availability could make more renters into homeowners so long as home prices do not appreciate significantly; conversely, higher prices could strengthen the economics of renting.
- **Value in some Subordinates but Significant Back-Ended Risks** — Though interest-only mortgages create significant back-ended risks in the collateral pools, many second-pay bonds still show sufficient protection from losses.

Global Securitized Products Research

Mary E Kane
+1-212-816-8409
mary.e.kane@citi.com

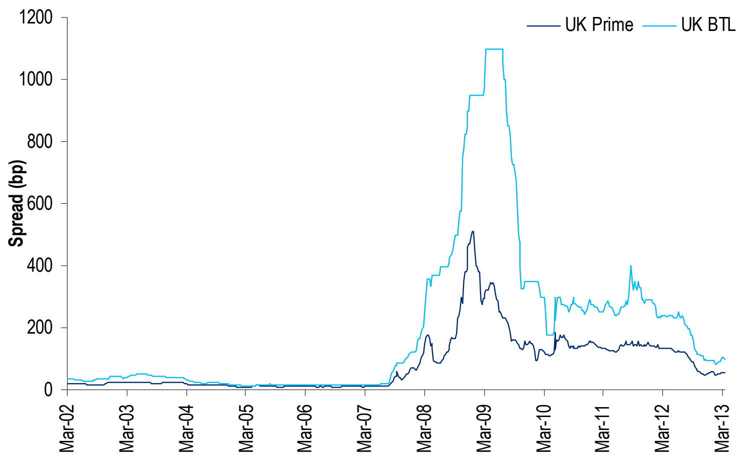
European Securitized Products

Ratul Roy
+1-212-723-6043
ratul.roy@citi.com

Himanshu Shrimali, CFA
+44-20-3569-4127
himanshu.shrimali@citi.com

Rajat Deshpande
+91-22-4277-5048
rajat.deshpande@citi.com

Figure 1. UK Prime and BTL RMBS Spreads to EURIBOR, Mar 02 – Mar 13 (bp)



Source: Citi Research

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UK Buy-to-let (BTL) Market Overview

UK BTL RMBS is one of our top calls for 2013 and we expect the sector to benefit from strong fundamentals and supportive technicals. Low interest rates and rising rents have been very positive for BTL performance. Citi economists expect UK rates to remain low until 2017 and we think that stable to improving house prices and strong rental demand should continue to support the sector when rates eventually start rising. The scarcity of new RMBS deals, even as the outstanding buy-to-let mortgage collateral and the UK rental market are growing, provides very positive technicals.

We think UK BTL RMBS offers attractive relative value compared to UK prime RMBS with negligible credit risk for the seniors. Senior BTL tranches pick up 48–112bp to 5YR UK Prime RMBS, depending on the shelf. UK BTL RMBS is one of the few long duration senior securitized exposures from a core country and can form part of a strategy to benefit from tightening credit spreads.

The back-ended default risk in BTL pools arises because of a high proportion of interest-only loans which then poses significant concerns for the collateral in case borrowers are not able to refinance. We outline a methodology to model BTL defaults based on loan maturity and indexed LTV and identify subordinate tranches likely to experience principal write downs in our stress analysis, as well as those which are more robust.

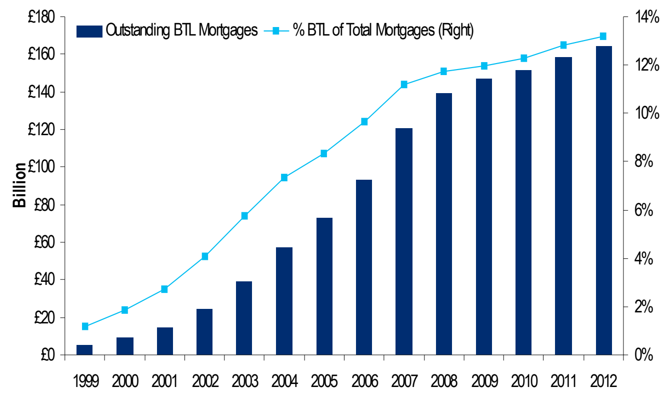
Collateral and Bond Universe

- **Impressive BTL Growth.** UK buy-to-let mortgage market has grown around 579% during the past decade to about £164 billion and represents around 13% of total mortgages outstanding in the UK (Figure 2). The BTL growth compares very favourably to the much lower 92% growth of overall UK mortgage market, during the same period. Gross buy-to-let mortgage lending increased at an average annual rate of 25% from 2010–2012 to register £16.4 billion in 2012, still 64% below the peak of 2007.

- **£38 Billion RMBS Market.** We estimate the size of the UK BTL RMBS market at roughly £38 billion, as of 2012 year end. About 67% of the outstanding RMBS deals are placed while the remaining are retained on originators' balance sheets (Figure 3). The placed BTL RMBS outstanding has shrunk by 44% since 2007 due to lack of new issue supply and associated run-off, creating very positive technicals.

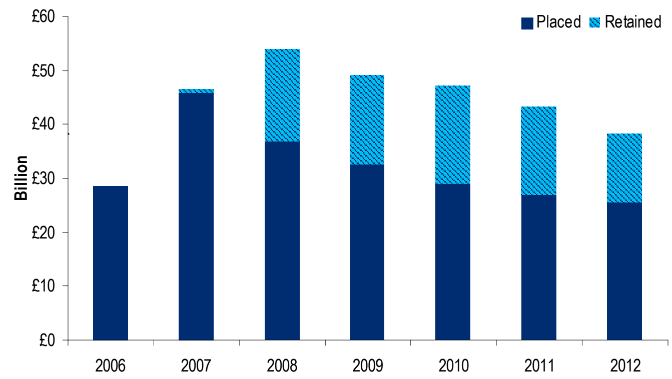
- **Concentrated Market.** The UK BTL RMBS sector is highly concentrated with only five major originators. Paragon, Bradford & Bingley, Capital Home Loans, Co-operative Bank, and Bank of Ireland account for all placed deals. Of these, only Paragon has brought a primary deal after the financial crisis. We provide a brief description of each originator in the Top Originators and Shelves section of this report.

Figure 2. Outstanding Buy-to-let Mortgages in the UK, 2006 – 2012 (£, billions)



Source: CML and Citi Research

Figure 3. UK Buy-to-let RMBS Outstanding, 2006 – 2012 (£, billions)



Source: Bloomberg, Concept ABS and Citi Research

Conducive Macro-economic Environment

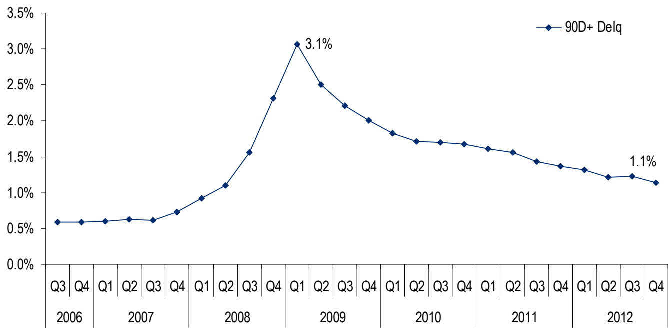
Low Interest Rates and Favourable Demographics

Recent living patterns of falling homeownership and rising propensity to rent combined with low borrowing costs and rising rents all favour the BTL product. The post 2008–crisis mortgage lending environment has been very challenging for home-buyers because of tighter underwriting criteria and rising down payments. As a result, more households are opting for renting than buying. Moreover, the prevailing low interest rates resulted in low debt service payments for BTL landlords, while the average rents have been increasing for the past few years. A majority of buy-to-let mortgages are linked to the Bank of England base rate or 3-month GBP Libor and both these rates have fallen since 2008, resulting in lower mortgage payments for the BTL landlords. The improved ability to service mortgages has led to a sharp fall in the number of delinquent mortgages (Figure 4).

The overall macro-economic environment continues to be conducive for the BTL sector in multiple ways, which we discuss below:

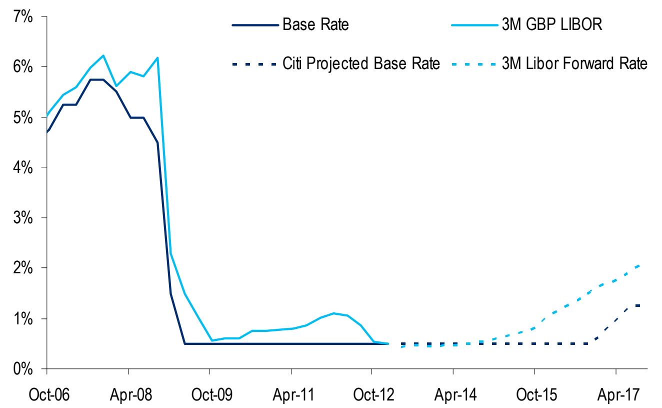
- **Rates to Stay Low for Long.** Citi economists expect that the Bank of England will keep the base rate unchanged at 50bp until 2017 and the forward curve points that 3M GBP Libor will remain below 1% until 2016 (Figure 5). Low interest rates significantly decrease the BTL mortgage payments because a high proportion of BTL pools are interest only.

Figure 4. Average 90D+ delinquencies for UK BTL Mortgage Pools, 2006 Q3 – 2012 Q4 (%)



Source: CML and Citi Research

Figure 5. Bank of England's Base Rate and 3-month GBP Libor, Oct 06 – Mar 2013 Actual and Apr 2013 – Oct 2017 Forecast (%)



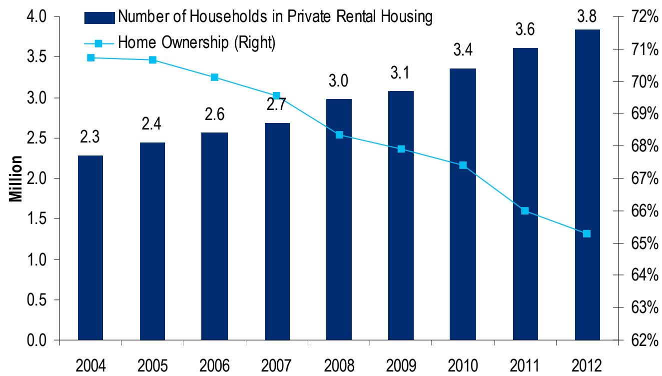
Source: Bank of England, BBA and Citi Research

- **Strong Rental Demand.** The demand for rental properties remains strong as more people are opting for rented accommodation. The number of households in private rental housing has increased 42% since 2007, registering roughly 3.8 million, according to the latest English Housing Survey by DCLG (Figure 6).

- **Falling Homeownership.** The decreasing home ownership rates show a broader shift to renting from owning. Average home ownership rates in England have declined to 66.0% from 70.6% in 2000 due to tighter underwriting criteria following the 2008 crisis. Home ownership is expected to decrease further to 64% by 2021, according to National Housing Federation forecasts.

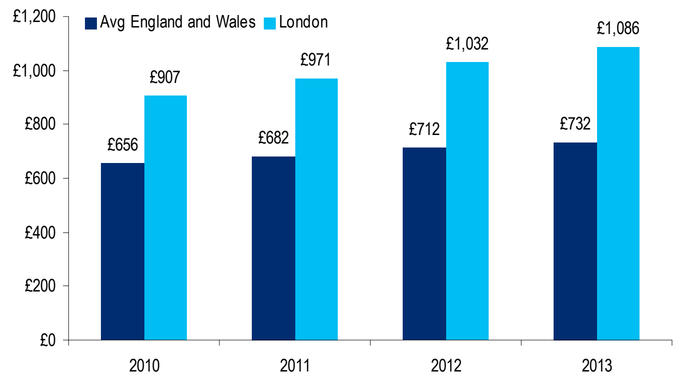
- **Rising Rents.** Average rents in England and Wales have increased even though house prices have moved sideways during the past four years. Current average rents for England and Wales are 13% higher than 2009 and London average rents has increased about 20%, showing the best rental performance in the UK (Figure 7). The BTL RMBS pools have a significant exposure to the strong rental markets of Greater London and South East England ranging from 23–67%.

Figure 6. Number of UK Households in Private Rental Housing and Homeownership Rate, 2004 – 2012 (Millions and %)



Source: DCLG and Citi Research

Figure 7. Average Monthly Rent in England and Wales and London, 2010 – 2013 (£)



Source: LSL Property and Citi Research

Risks from Lower Rental Yields are Low

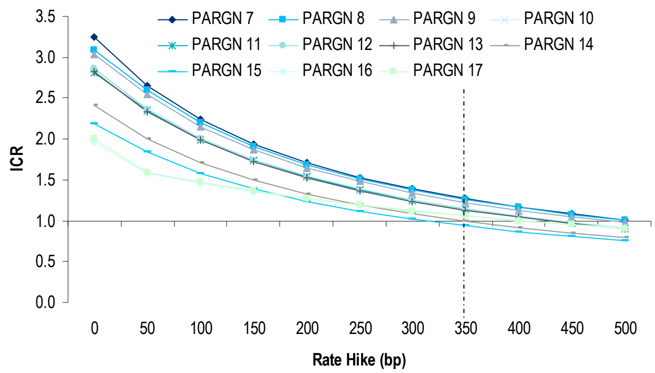
Rising rates or falling rents hurt BTL economics as they reduce yield available to the landlord. As discussed above, the extended low interest rate environment will directly benefit the UK BTL sector but the more important question is how will credit performance fare when rates start rising? We think that the effect will not be as disastrous as widely expected.

- **Robust Interest Coverage.** The high interest coverage ratio of UK BTL RMBS pools enables them to withstand significant rate rises, in our opinion. We analyse the loan level data for Paragon and Leek programmes, and estimate that these pools can withstand 250–350bp of rate hikes and still have full interest coverage (Figure 8 and Figure 9). We assume stable rental yields for this analysis.

- **Positive Rental Outlook.** We think that strong rental demand will continue to support UK rents and that the risk of rents falling significantly is low. The success of Help-to-Buy schemes announced in the 2013 UK budget could potentially reverse the strong rental demand as more people shift back from renting to owning. However, easier credit availability could also lead to higher house prices, further strengthening the economics of renting.

- **Risk of Low Rents and High Rates.** The worst case scenario for UK BTL market is falling rents and house prices with increasing interest rates, leading to shrinking debt-coverage and rising defaults and losses. Such a scenario could happen, in theory, when growth rates are low and rates are high (for example, to combat inflation) as happened in the 1970s following an external oil-price shock. However, the impact on rents would be less obviously disastrous. Rising rates would deter aspiring homeowners and push them to the rental market, probably creating a floor on how far rents could fall.

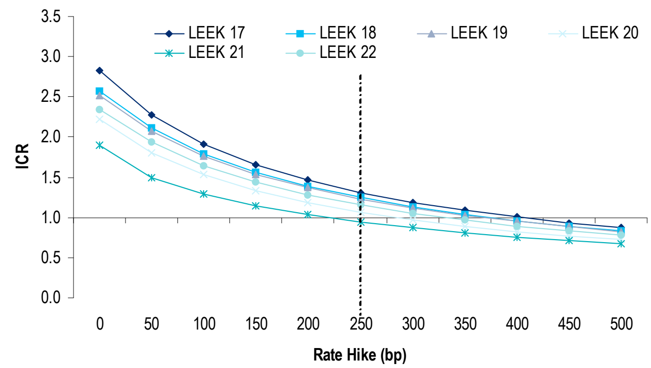
Figure 8. Average Estimated ICR for PARAGON Deals with Rising Rates*



*We assume constant rental yields

Source: Company Filings, INTEX, Halifax, LSL Property and Citi Research

Figure 9. Average Estimated ICR for LEEK Deals with Rising Rates*



*We assume constant rental yields

Source: Company Filings, INTEX, Halifax, LSL Property and Citi Research

UK Housing Outlook: Limited Downside but Expect Slow Recovery

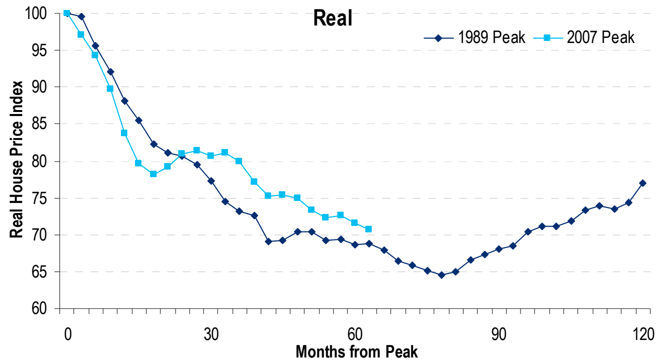
UK housing market is likely to remain sluggish for 2–3 more years but we think there is limited downside from current levels. Absence of overbuilding and UK government policy initiatives such as the FLS and the recently announced Help-to-buy schemes should support house prices. To gauge the extent of future house price decline, we compare the current housing correction to the 1990's crisis and find striking similarities.

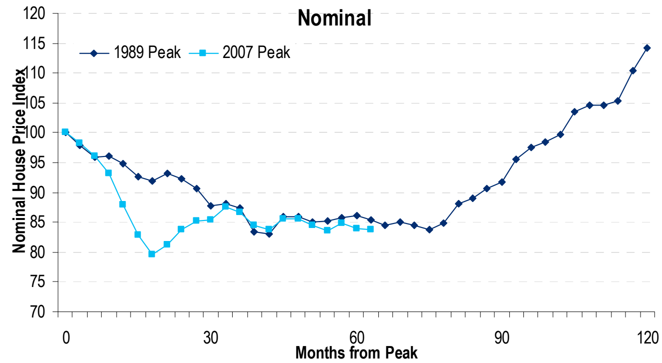
- **House Prices to Move Sideways.** Citi economists expect nominal UK house prices will move sideways for another 2–3 years and keep drifting lower in real terms following which a meaningful recovery could start. Post 1990's crisis it took roughly 8 years for the house prices to regain their peak and Citi economists expect that the recovery will take longer this time around.

- **Similarity to 1990's Crisis.** House prices post 2007 are tracking the 1990 crisis house price trajectory in both real and nominal terms. Real house prices declined 29% 63 months after peaking in Q3 2007 which is comparable to the 31% drop 63 months after the 1990's peak. Nominal prices fell 16% and 15% 63 months after the peaks in 2007 and 1989 respectively (Figure 10).

- **Limited Housing Supply Supports Prices.** Strict planning regulations and limited land space have kept UK housing supply in check. Number of housing starts per 1000 people remained 3–4 during the lead up to the current crisis and has stabilised at around 2 post crisis. This is much better compared to countries such as the US which had housing starts per 1000 at 7 and Ireland and Spain which had housing starts per 1000 at 19–20 during the boom period and has now settled at 1–2.

Figure 10. UK House Price Decline in 1990s and 2007 Crises in Real and Nominal Terms





Note: We average the Halifax and Nationwide house prices

Source: Lloyds TSB, Nationwide and Citi Research

Efficient Recovery and Servicing Process

The recovery process of BTL lenders is more efficient than owner-occupied mortgage lenders due to the availability of multiple options. A BTL lender can either appoint a receiver of rent and collect rental cash flows, or evict the tenant and repossess/sell the property quickly. On the other hand, owner-occupied mortgage lenders have to go through a relatively lengthy and costly process of foreclosing properties through the courts. We briefly discuss the advantages of the BTL enforcement process below:

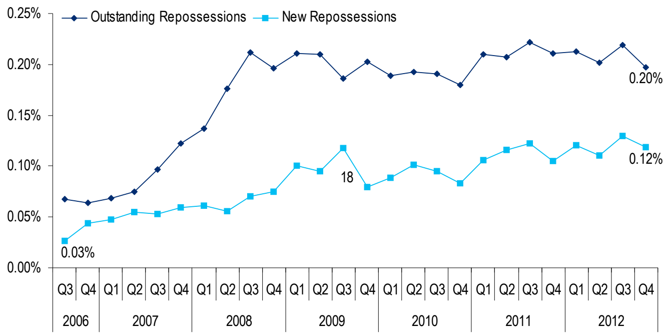
- **Receiver of Rent (RoR).** The “Receiver of Rent” strategy employed by most BTL lenders ensures better recovery as long as the delinquent property is generating sufficient rental income. The RoR mechanism enables the lender to re-direct rental cash flows from the underlying property to making mortgage payments. Also, this incentivises landlords to make missed payments and inject additional equity (if required) to take back control on the property.

- **No Moral Hazard.** The BTL lenders are free to quickly repossess and dispose non-performing properties without any political pressure or moral hazard concerns. On the other hand, regulators generally expect owner-occupied lenders to show forbearance and use repossession only as the last resort.

- **Diverse Income Sources.** Professional landlords maintain a diverse property portfolio to minimise void periods and maintain stable rental income. They are likely to use income from multiple properties to make mortgage payments. In contrast, an average household generally depends on the primary income source to make mortgage payments and is more susceptible to unemployment shocks.

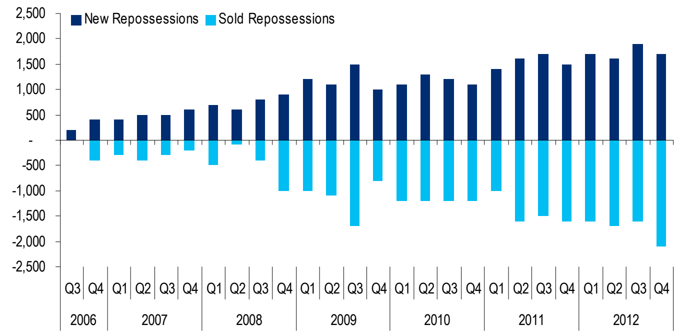
- **Repossession Sales Supported by Liquid Property Market.** UK BTL lenders have kept outstanding repossessions low by disposing of properties quickly. This highlights a well functioning UK property market with sufficient demand for repossessed properties. Total outstanding repossessions remain range bound between 18–22bp in the last four years even as new repossessions edged up from 6bp in 2008 Q1 to 12bp in 2012 Q4 (Figure 11 and Figure 12).

Figure 11. UK BTL Outstanding and New Repossession Rates, 2006 Q3 – 2012 Q4 (%)



Source: CML and Citi Research

Figure 12. UK BTL New and Sold Repossessions, 2006 Q3 – 2012 Q4 (Number of Properties)



Source: CML and Citi Research

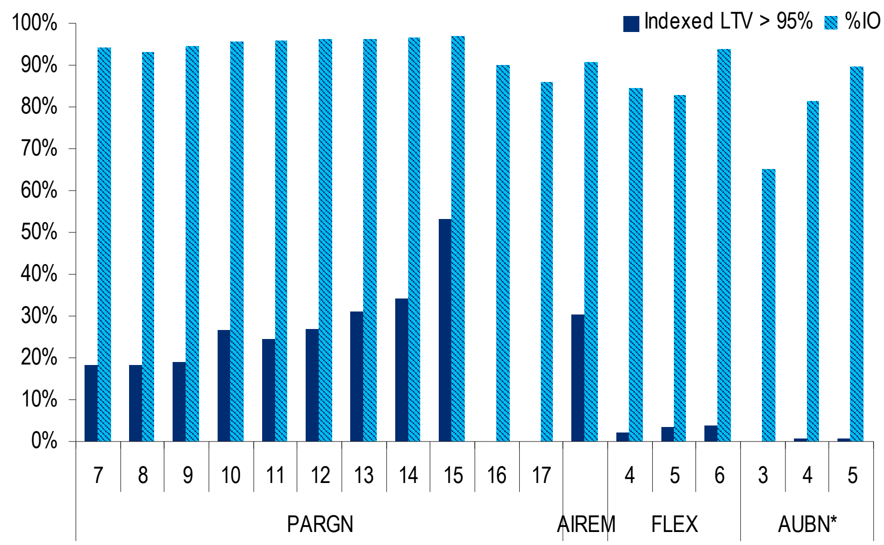
Stressing UK BTL RMBS

UK BTL RMBS principal repayments depend upon two sources: 1) Issuer calls and investor puts, and 2) Collateral cash flows. Most outstanding BTL bonds were not called by the issuers on their optional redemption dates and are now pass-through securities. However, LEEK 17, 18, and 19 deals were restructured on their call dates to include an investor put option exercisable after June 2016, December 2016, and June 2017, respectively. The stress methodology described below is not applicable for LEEK deals because of a high likelihood of the issuer honouring the put option. We provide a brief description of the LEEK re-structuring in the next section of this report and analyse the remaining deals, which depend on the performance of the underlying mortgage collateral, below.

We expect back-loaded defaults in UK BTL RMBS because a significant proportion of BTL pools is comprised of interest-only and high LTV loans (Figure 13). Borrowers could potentially face difficulty in refinancing high LTV IO loans unless they are capable of injecting sufficient equity to satisfy tighter expected underwriting criteria compared to the time that the loan was originated. We understand that current strong collateral performance of these deals is supported by high debt-service coverage due to low interest rates and benign rental markets. Should buy-to-let economics not be as favourable in the future, such risky high LTV IO loans have a higher chance of default.

In order to stress BTL deals by capturing the risk of back loaded defaults, we assume that that all high LTV loans would default at maturity. This approach allows us to predict both the level as well as the timing of defaults. However, we realise that many high LTV loans are supported by high rental income and good credit quality borrowers. Also, LTVs would improve when house prices start recovering. *So estimated defaults using this approach are conservative and should be considered as a severe stress scenario.*

Figure 13. Proportion of High LTV (> 95%) and Interest-Only Loans in UK BTL RMBS Deals, as of last Reported date (%)



* Indexed LTV not reported for AUBN

Source: Investor Reports and Citi Research

Methodology and Assumptions

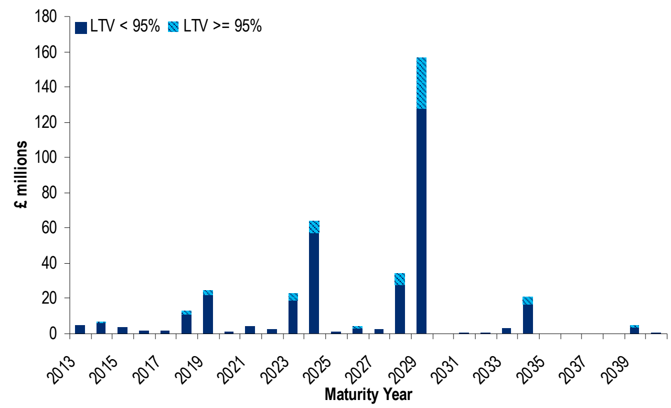
Defaults

We use indexed loan-to-value ratios and loan maturity schedule to project the timing and level of defaults. The interest only loans are more likely to default at maturity because of relatively low mortgage payments particularly in a low interest rate environment.

We utilise Paragon's loan-level data to estimate the updated valuation of the property backing each loan using the latest reported valuation and Halifax's regional house price indexes. We anticipate UK house prices to be stable in near to medium term so we assume that current indexed LTV of these loans would remain roughly constant going forward. We assume that all loans with estimated indexed LTV greater than 95% will default and the remaining will repay at their maturity dates. The availability of loan level data enables us to construct precise maturity schedule by LTV buckets for Paragon deals. We show the schedule for PARGN 7 deal in Figure 14 for illustrative purposes.

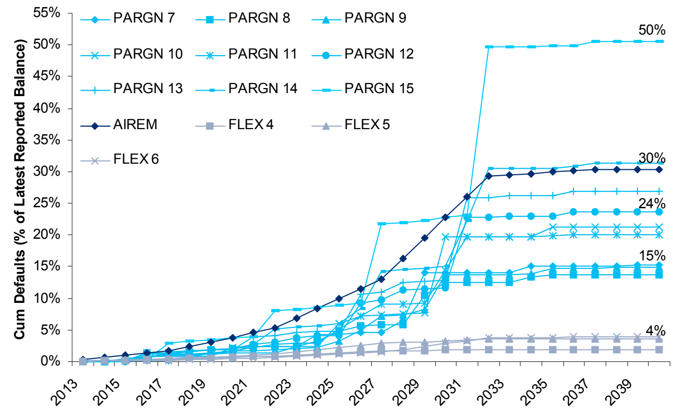
As loan level data is not available for Aire Valley and First Flexible, we use the same approach on pool level maturity schedule and reported indexed LTV buckets to predict defaults. For instance, roughly 30% of AIREM mortgages have indexed LTV greater than 95% so we estimate AIREM's cumulative lifetime defaults at 30% and predict the default timing based on the pool level maturity schedule. Figure 15 shows the default curves estimated using this approach for PARGN, AIREM, and FLEX pools.

Figure 14. PARGN 7 Maturity Schedule by Estimated Indexed LTV Buckets



Source: Investor Reports, INTEX and Citi Research

Figure 15. Estimated Cumulative Default Curves for UK BTL RMBS Deals, 2013F – 2040F (%)



Source: Investor Reports, INTEX and Citi Research

Prepayments

We expect prepayments to remain low because of tight underwriting conditions today and low interest rates. Average total repayment rates (including scheduled payments) on UK BTL RMBS have been range bound for the past three years, registering around 4% according to Moody's data. We assume a constant repayment rate based on recent reported data for stressing these deals.

Loss Severity and Recovery Lag

We assume loss severity of 50% and recovery lag of 12 months. Buy-to-let properties in general have higher loss severity than owner-occupied homes because tenants are less likely to maintain the property in good condition. Moreover, since most BTL lenders employ the receiver of rent strategy, they are likely to liquidate only those properties which are not generating sufficient rental income and are arguably in poor condition. Keeping these points in mind, we think that 50% loss severity is reasonable for stressing BTL pools.

Results — Seniors Protected but Some Subordinates Vulnerable

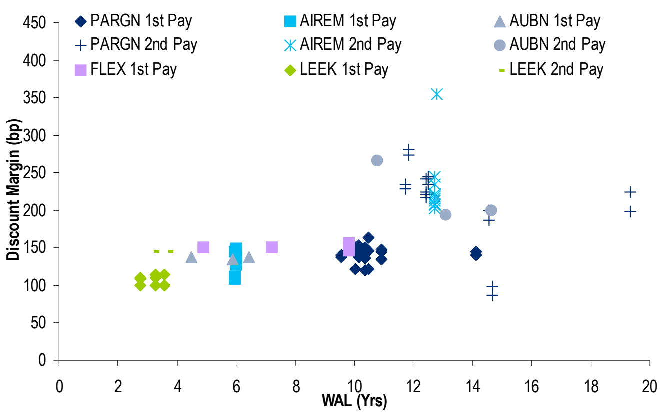
We analyse PARGN, AIREM, AUBN, and FLEX deals in INTEX using the default, prepayment and loss severity assumptions described earlier. Due to unavailability of indexed LTV and maturity data for AUBN we use latest reported default assumptions. We assume constant delinquencies for triggers. We estimate discount margin of each bond using Markit prices and also estimate WAL and implied write-down, subject to above assumptions. We summarise the results of our analysis below:

- **Senior Classes Money Good.** The senior-most classes of all the deals we analysed are money good in our stress scenario, implying negligible credit risk. We see senior BTL classes as good alternatives to UK prime RMBS, offering attractive pickups ranging from 48–112bp. The discount margins on these BTL bonds range from 100–164bp for WALs ranging from 3–14 years (Figure 16).

- **Value in Short Duration First Pays.** Short WAL (3–6YR) senior notes of LEEK, AIREM, AUBN, and FLEX offer good value compared to similar maturity UK prime RMBS at EURIBOR+ 43–52bp, in our opinion. These BTL notes are not only money good but also relatively short duration compared to PARGN senior notes, pursuant to our analysis. Spreads for LEEK, AIREM, AUBN, and FLEX senior notes range from roughly EURIBOR +100–150bp (Figure 16).

- **Certain Second Pays Attractive.** We like certain second pay notes because they offer a significant spread pickup to seniors for a small increase in WALs. PARGN 8, 9, and 11 second pays pick up 82–136bp to corresponding first pays for only 1.7–2.4YR longer WALs. Similarly, FLEX 4 second pays pick up 89bp for roughly same WAL as the corresponding first pay (Figure 17). At the same time these second-pays receive their entire principal under our assumed stresses.

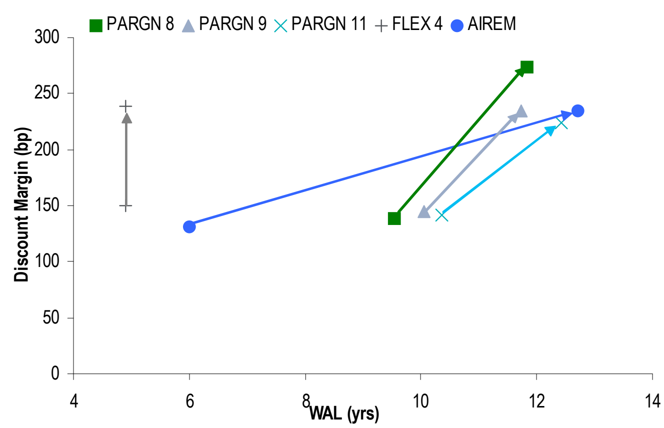
Figure 16. Relative Value Among UK BTL Shelves — Estimated DMs and WALs



* LEEK WALs to optional redemption dates

Source: INTEX and Citi Research

Figure 17. Attractive Pickups for 2nd Pays — Estimated Change in DM and WAL from 1st to 2nd Pay Notes of Select BTL Deals

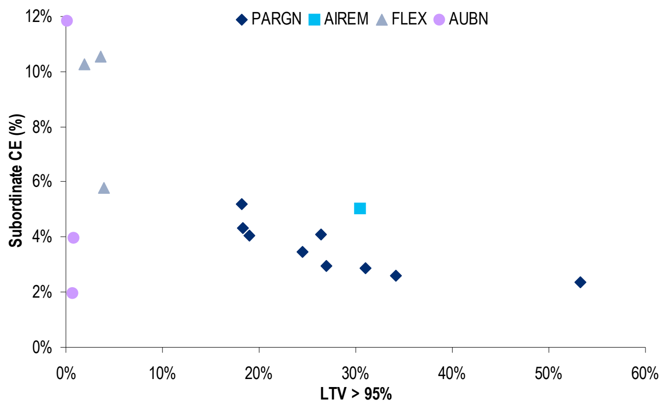


Source: INTEX and Citi Research

- **Implied Write-down on Many Other Subordinates.** Subordinate notes of many deals we examined experience principal write-downs in our stress scenario. PARGN 9–15 last pays suffer write-downs ranging from 5–100% depending on the deal. While these bonds are trading at a greater discount to last pay notes of older vintage PARGN deals, such high write-downs are not priced in. AUBN 4 last pay tranche also experiences roughly 94% principal write-down in our stress scenario and is currently trading at a low cash price of around 39 cents to a dollar (Figure 19).

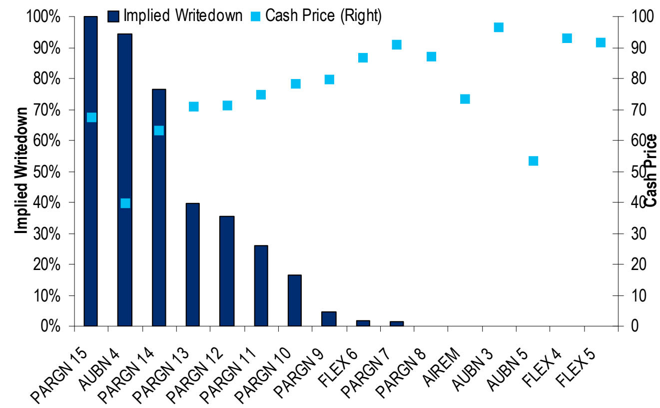
- **Call Possibility of Recent Deals.** Over and above the likelihood of principal losses on bonds, we believe that several deals may get called if it is in the interests of the originator to do so. Recent PARGN bonds with a high weighted average cost of financing fall in this category. If new issue spreads keep tightening, these bonds should get called and the collateral pool refinanced at tighter spreads.

Figure 18. Subordination of Last Pay Bonds Compared with Proportion of Loans with 95%+ LTV



Source: INTEX, Investor Reports and Citi Research

Figure 19. Estimated Implied Write-downs and Markit Cash Prices for Last Pay Bonds



Source: Markit, INTEX and Citi Research

Top Originators and Shelves

We provide a brief overview of top BTL originators in this section and highlight the collateral and structural characteristics of their shelves. While most BTL pools are predominantly backed by investment properties, some shelves have a larger proportion of owner-occupied properties. For instance LEEK deals have greater than 50% owner-occupied loans while most PARGN deals are backed by only rental properties. All the BTL pools have a high percentage of interest-only loans and are concentrated in trophy locations of Greater London and the South East.

BTL RMBS are generally structured as static standalone deals with the exception of Aire Valley (AIREM). AIREM is a master trust structure but is currently in wind down and the pool is now static. While most BTL deals had an issuer call option, none of the outstanding deals were called. As a result, all the BTL tranches are now priced as pass-through notes to full extension except LEEK. LEEK 17–19 deals were restructured before their call dates to include an investor put option in 2016 and 2017. Figure 20 highlights the salient characteristics of all the major BTL shelves.

Figure 20. Summary of Top UK BTL RMBS Shelves

	Aire Valley (AIREM)	Paragon (PARGN)	First Flexible (FLEX)	Leek (LEEK)	Auburn (AUBN)	Brunel (BRNL)
Overview						
Originator	Bradford & Bingley	Paragon	Paragon	Co-operative Bank	Irish Life and Permanent	Bank of Ireland
Loan Level Data Availability	No	Yes	Yes	Yes	No	No
Current Outstanding (£ billion)	7.6	7.6	0.3	4.9	4.6	2.6
# Deals Outstanding	1	11	3	6	5	1
Collateral Characteristics						
% Owner Occupied Loans	21%	0% - 1%	1% - 14%	50% - 81%	0% - 14%	42%
% Interest Only	91%	90% - 97%	83% - 94%	77% - 82%	67% - 95%	77%
% Negative Equity	21%	9% - 21%	1% - 2%	6% - 52%	Not Available	0%
% Professional Landlords	Not Available	51% - 85%	49% - 60%	Not Available	Not Available	Not Available
% South East + Greater London	53%	34% - 54%	62% - 67%	41% - 50%	23% - 40%	52%
% Flexible Mortgages	Not Available	1% - 3%	75% - 84%	0% - 0	23% - 60%	Not Available
Structural Detail						
Structure Type	Master Trust (Currently in wind down)	Static Pool	Static Pool	Static Pool	Static Pool	Static Pool
Current Credit Enhancement	21.6%	12.6% - 27.6%	45.3% - 52.2%	64.2-72.3%	29.8%-50.8%	20.0%
Payment Priority	Strictly Sequential	Sequential/Pro Rata	Sequential/Pro Rata	Sequential	Strictly Sequential	Sequential/Pro Rata
Callablility	Not Called	PARGN 17 - Aug 2016	Not Called	Not Called, LEEK 17–19 putable in 2016–2017	Not Called	Not Called
Excess Spread	0.3%	0.68% - 2.0%	0.64% - 1.84%	0.0% - 3.4%	0% - 0.48%	1.80%
Reserve Fund	5.0%	2.3% - 5.3%	10.2% - 13.2%	3.3% - 6.0%	1.9% - 11.78%	4.10%
Seller's Share	27.0%	Not Applicable	Not Applicable	Not Applicable	Not Applicable	Not Applicable
Legal Final Maturity	2066	2034 - 2044	2034 - 2036	2037 - 2050	2041 – 2045	2039
Current Coupon	0.44% - 2.21%	0.29% - 3.26%	0.77% - 3.19%	0.42% - 2.02%	0.44% - 2.21%	0.39% - 1.05%
Indicative WAL (First Pay Notes)	6 years	10–14 years	5–12 years	3–4 years	5–10 years	3 years
Indicative DM (First Pay Notes)	135bp	135–150bp	133–165bp	100–110bp	145–155bp	120bp

Source: Investor Reports, ABSNet, Bloomberg and Citi Research

Irish Life and Permanent/CHL Home loans - AUBN

Irish life and Permanent originated BTL deals under the AUBN shelf. AUBN 3–5 are placed transactions where as AUBN 6–7 are retained.

The AUBN deals are predominantly BTL with owner-occupied balance at origination ranging from 0–20%. Current LTVs for the deals range from 70–93% with 23% - 40% of the collateral concentrated in London and South East England. The AUBN pools contain 67–95% interest-only loans and 23–60% are “flexible mortgages.”[1]

Auburn 3–7 notes amortise strictly sequentially throughout the lives of the deals, this helps in building credit enhancement and shortening senior note WAL. Senior credit enhancement at origination for Auburn 3–5 ranges from 7.5–14.7% and currently stands at 29.8–50.8%.

While the originator has an option to employ the receiver of rent strategy in case of default, there are currently no properties on which this strategy is being applied.

[1] Flexible mortgages allow over payment, under payment, redraw, and a payment holiday for 3–12 months

Paragon Group – PARGN and FLEX

PARGN

Paragon is a buy-to-let specialist lender focused on professional landlords. Paragon relies heavily on securitization to fund its buy-to-let business and is the only issuer that has come to market post crisis, though in small sizes.

The collateral underlying the PARGN 7–17 deals consists of 90–97% interest only loans and 51–85% of the loans are to professional landlords. London and South East England exposure ranges from 34–54% across deals. Indexed LTVs range from 67–90% and 9–21% of loans across deals are underwater according to our analysis.

PARGN 7–15 were not called on their respective call dates resulting in a coupon step up. PARGN 16 and PARGN 17 do not have a coupon step up on their call dates but benefit from a turbo amortization feature.[2] PARGN 7–10 are currently in pro-rata amortisation mode whereas PARGN 11–17 can amortise only sequentially. PARGN deals have origination senior credit enhancement of 11.9–22.0% which currently stands at 20.8–27.6%.

Paragon employs the receiver of rent strategy to manage defaults and number of loans in receiver of rent ranges from 53–187 for PARGN 7–15 and there are no loans in receiver of rent in PARGN 16–17.

FLEX

FLEX 4–7 are deals originated by Britannic Money which was acquired by Paragon and rebranded as Mortgage Trust in 2003.

FLEX 4–6 contain approximately 86–99% buy-to-let mortgages and have 75–84% flexible mortgages. 83–94% of the underlying pools are interest-only loans and 49–60% of the loans are concentrated in London and the South East.

The FLEX 4–5 amortise strictly sequentially whereas FLEX 6 can amortise sequentially or pro rata based on certain performance triggers.

Co-operative Bank - LEEK

The Co-operative bank lends only to experienced BTL landlords and limits the total exposure of the landlord to £1.5 million across all lenders. The LEEK 17–19 are placed transactions where as LEEK 20–22 are retained.

The buy-to-let component of the LEEK deals ranges from 19–50% across deals. The pools have 77–82% interest-only loans and have a concentration of 41–50% in London and the South East. Average current LTV ranges from 70–91% and 6–52% of the loans across deals are underwater according to our analysis.

The LEEK 17–19 deals were not called on their call dates in 2011 and 2012 but were in turn restructured; we describe the restructuring below. All the placed LEEK deals amortise strictly sequentially; this helps in amortising the seniors faster thereby shortening note WAL.

While originator has an option to employ the receiver of rent strategy to resolve defaults, there is no disclosure indicating that the strategy is being employed.

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[2] "Paragon — Dominant BTL Issuer" – European Securitized Products Weekly, 7 September 2012, Citi

Leek Re-Structuring

The Co-operative bank announced in March 2011 that it will not call the LEEK 17, 18, and 19 transactions on their step-up dates in June 2011, December 2011, and June 2012, respectively. To compensate the investors, the bank proposed some modifications to the structure, which the note holders later approved. We briefly summarise the main highlights of the restructuring below:

- **Investor Redemption Option.** The note holders are provided an investor redemption option exercisable five years after the original step-up dates
- **Enhanced Credit Support.** The bank provided subordinate loans to each issuer to purchase UK gilts, providing additional credit support to the notes. The amount of gilts purchased were £137 million for LEEK 17, £163 million for LEEK 18, and £158 million for LEEK 19. The origination credit enhancement for these transactions ranged from 15.4–21.6% which currently stands at 64–71%.
- **Additional Coupon for Class A Notes.** The Class A note holders in these transactions will receive a redemption premium which would depend on the number of payment dates between the original step-up date and the final redemption date and is capped at 5% of the Class A notes outstanding on the relevant step-up date. This effectively translates to the put price of 105 for the senior notes.

Figure 21. Optional Redemption Dates of Restructured LEEK Transactions

Deal	Notes Outstanding	Original Step-up Date	Put Date*
LEEK 17	456,023,983	Jun-11	Jun-16
LEEK 18	540,454,789	Dec-11	Dec-16
LEEK 19	529,004,431	Jun-12	Jun-17

* Investor redemption option is exercisable after this date

Source: Company Filings and Citi Research

Bradford and Bingley – AIREM

Aire Valley (AIREM) is the only master trust and the largest component of the UK buy-to-let market, contributing 27% to it. It is being managed by the UK Asset Resolution (UKAR) entity and is being wound down.

The AIREM master trust consists of 79% buy-to-let mortgages and has 91% interest only loans. 53% of the loans are concentrated in London and the South East as of the latest investor report. The average indexed LTV of the pool is 84.3% and 21.0% of the loans are underwater.

The AIREM master trust is in breach of its non asset trigger[3] which has forced it into early amortisation with a sequential pass through payment of the notes. The senior credit enhancement of the Aire valley master trust stands at 21.6% which includes a reserve fund of 4.99%. The seller's share is 27.0% which is now locked out from receiving principal payments enabling faster amortisation of the funding share.

Aire Valley employs LPA receiver to resolve defaults and has sold 1,730 properties amounting to £260 million using the receiver.

Bank of Ireland – BRNL

Bank of Ireland originated loans through its subsidiary Bristol & West PLC and is no longer originating new loans.

Buy to let loans form 52.2% of BRNL 2007-1 and the deal has an average reported LTV of 71.2% as of January 2013. The collateral has a 51.5% concentration in the South East and London and 77.0% of the loans are interest only.

[3] "Aire Valley — Once More Unto the Breach" - European Securitized Products Weekly, Citi, 11 May 2012

The deal had a step up date in November 2010 but it was not called; as a result, the interest margin of the notes stepped up. The senior credit enhancement of this deal was 14.6% at origin which now stands at 20.0%.

Even though the servicer has an option of appointing a receiver of rent in the event of a default there are no disclosures indicating that this strategy has been followed.

Summary — Good UK Prime Alternative

We think that UK BTL RMBS offers very good value despite high proportion of interest-only loans and relatively high loan-to-value ratios. As demonstrated in our stress analysis, all senior BTL notes are money good even in a fairly conservative scenario where all loans with greater than 95% LTV default with 50% loss severity. Moreover, several mezzanine notes are also well protected, offering attractive pickups to seniors for slightly longer WAL. BTL sector offers a wide range of WALs from 3–14 years. Shorter WAL notes look particularly attractive compared to similar maturity UK prime RMBS while longer WAL notes could become part of a strategy to benefit from tightening credit spreads. The back-ended risks due to interest-only loans require additional caution while investing in subordinates but many subordinates still show sufficient protection from losses.

Notes

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Appendix A-1

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