

Scope sees favourable conditions for a revival of Spanish SME CLO transactions placed with investors. The significant decrease in spreads demanded for investment grade tranches allows for economically viable transactions again.

Scope expects that the return of investors interested in real economy may reactivate the public issuance of Spanish SME securitisations intended for placement rather than retention purposes.

The credit view of Scope on Spanish SME assets is not based on a top-down approach in which a blanket assumption applies to all portfolios with only very minor differentiation of credit quality. The Spanish economy can become a source of high quality SME securitisations even when higher-leveraged structures are used. This is particularly true if originators select granular portfolios without adverse selection of credits.

Scope has analysed the economical viability of average pre-, during- and post-crisis structures. The analysis covers 48 Spanish SME CLO transactions from 2003 to 2014.

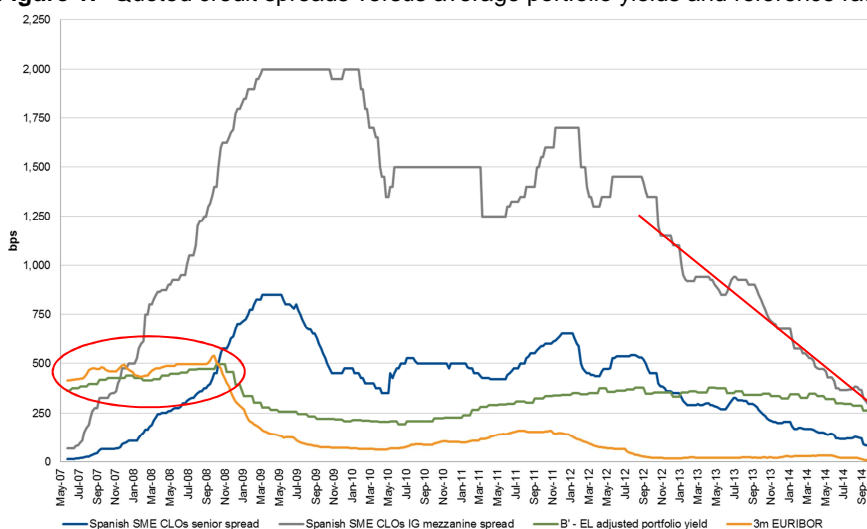
### Placement Opportunity Opens for Spanish SME CLOs

The spreads demanded for senior and investment grade mezzanine tranches have fallen to levels that now allow for viable securitisation structures in a context of SME portfolio yields slightly above 4%. This may signal that 2015 could see the first issues of Spanish SME CLOs for placement since 2007.

Scope believes that at present Spanish SME portfolio yields adequately reflect the credit risk of SME portfolios (in addition to profit margins and liquidity). This is demonstrated by the fact in recent securitisations the excess spread covers default losses.

Yet, capital structures (i.e. tranching and credit enhancement) reflect inflated credit views that often indicate high default expectations by credit rating agencies since 2010. This fact was offset by note margins well below market references, particularly for the mezzanine tranches.

**Figure 1.** Quoted credit spreads versus average portfolio yields and reference rate



Source: Bloomberg, JPMorgan and Scope.

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Figure 1 shows that the spreads demanded for senior and investment grade mezzanine tranches are back to viable levels. The downwards trend could be maintained if investors enter the market again and/or as a result of the ECB ABS purchase programme.

In Scope's view, the current base case performance of Spanish deals allows for an increase in leverage. This is because the yield on the first loss piece would still be positive even after coverage of base case losses from 'B'-quality portfolios. The standard Spanish SME loan portfolio yield is sufficient to service the weighted average cost of the liabilities of a securitisation after accounting for credit losses.

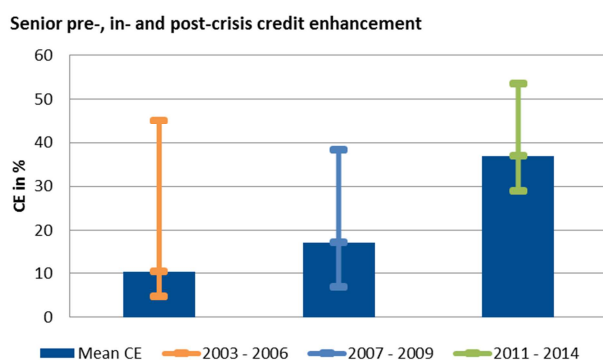
The quoted credit spreads on Spanish SME securitisation notes reflect the perception of lower risk by investors. This more positive perception is now supported by: i) the correction in real estate prices—including severe provisions and write-offs of bad debt exposures; ii) the restructuring of the Spanish banking system, which has effectively bailed-out the savings banks sector; and ii) the resolution of the Spanish sovereign credit crisis.

Granular European securitisations have shown robust credit performance through the past crisis. As a result, such transactions would not deserve a regulatory capital penalty different from that applied to covered bonds, when considering comparable ratings levels.

## Evolution of Credit Enhancement Levels

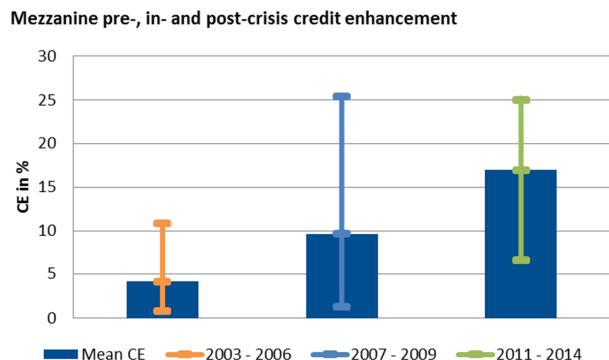
Figure 2 and Figure 3 compare the pre- and post-crisis average capital structures in Spanish SME transactions. They show that they have evolved towards increased credit enhancement levels for the senior and investment grade mezzanine tranches.

**Figure 2. Senior CE development**



Source: Bloomberg and Scope.

**Figure 3. Mezzanine CE development**



Source: Bloomberg and Scope.

Extremely high credit enhancement levels are evident in the implicit high loss multiples<sup>1</sup> when compared with a hypothetical (already stressed) base case taken from the current environment. An average credit enhancement of 37% was necessary to support senior ratings that were not even AAA during the post-crisis period, given counterparty and country risk limitations. And yet, excess spread and recovery cash flows have allowed cash reserves to remain adequately funded and even to be topped up back to the levels required by the structures.

<sup>1</sup> Loss multiples indicate the number of times a base-case loss expectation from the portfolio of assets is covered by credit enhancement available to a given tranche.

The high credit enhancement levels (reduced leverage) in post-crisis structures contributed to the lack of viability of securitisation as a funding tool for the real economy in Spain. Originating banks instead used securitisation as a tool to improve their liquidity ratios and also obtain cash they could use for carry trades investing in sovereign debt.

## The Case of the Yield for First-Loss Investors

Current spread levels have led to structures that no longer result in negative yields for the first-loss piece holder. Scope has analysed the implicit yield for the holders of the first-loss piece of Spanish SME CLO securitisations overtime, considering the average structures from pre-, during- and post-crisis periods. The implicit yield on the first-loss piece can be used as an indicator of the economic viability of a proposed structure.

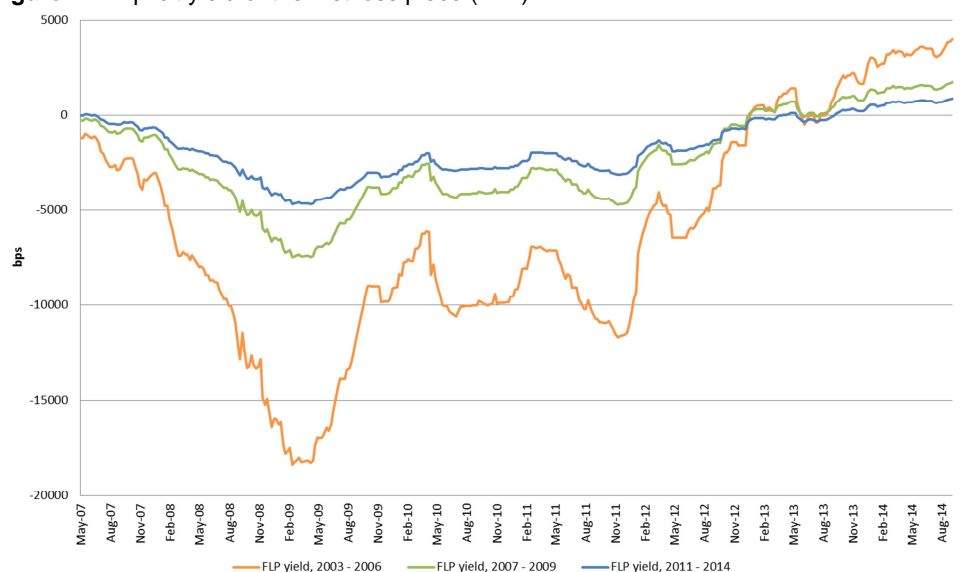
The excess spread available to the first-loss piece results from portfolio yields (i.e. average rate for lending to SMEs after credit losses) and credit spreads quoted in the market (i.e. a proxy of the margins demanded by investment grade investors).

Scope has deducted expected credit losses from the portfolios, so the analysis represents a base-case view of the economic viability of pre-, during- and post-crisis structures. Negative yields on the first loss piece indicate unsustainable leverage levels.

Figure 4 shows that today's environment would allow pre- and post-crisis structures be economically viable again without direct negative carry issues for first loss piece investors. The figure also shows the higher volatility of returns to be expected when leverage is higher.

The volatility levels observed for the first loss piece yields capture the impact of market concerns that are not related to credit. Most notably, the very large negative values in 1H09 reflect the uncertainties about the resolution of the real estate bubble. The lack of reliable market quotes during the period when markets were closed is another important factor in explaining the observed volatility.

**Figure 4.** Implicit yield of the first loss piece (FLP)<sup>2</sup>



Source: JPMorgan and Scope.

<sup>2</sup> Negative excess spread for the first loss piece can be seen as additional running costs borne by the originator of a securitisation when it is also the first loss investor.

The results also reflect the portfolio yields and reference rates shown in Figure 1. Structures today would be further supported by the currently very low level of the prevalent reference interest rate (three-month Euribor), which Scope expects will remain stable. Low Euribor rates benefit transactions because Spanish originators did not transfer the rate reductions to SME customers after 3Q08 to cover for higher expected credit losses, thus increasing excess spread available to new securitisations.

Notably, the circled curve section in Figure 1 reveals the conditions of a credit bubble where money would have been handed to SME enterprises with a negative credit premium on the cost of funds. This would explain the poor credit performance of some loans originated until mid-2008.

This analysis is based on simplified three-tranche structures that mimic the average credit enhancement levels shown in Figure 2 and Figure 3 above for the pre-, during- and post-crisis periods.

## Spanish SME CLOs at the Turning Point

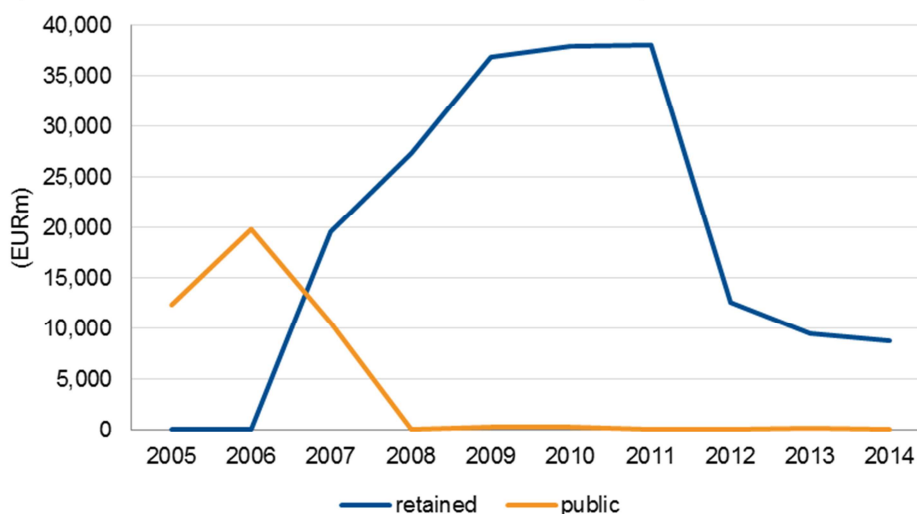
SME securitisation in Spain is now at a turning point: i) there is real-money investor appetite; ii) liquidity is no longer an objective for originators; iii) the macroeconomic environment is improving; and iv) European authorities want to promote SME lending and securitisation is seen as the right tool for funding such credit investment.

Figure 5 shows that public issuance stopped at the time where the yield available to first loss piece investors, the excess spread to equity investors, became negative (as shown in Figure 4). Since August 2013 this yield has been positive again. This can be interpreted as an indicator for the ability to create viable structures again. In May 2013 the ECB had announced initiatives to support viable markets for SME securitisation.

Late 2014 saw the first significant issuance of a Spanish SME CLO in Spain, which involved at least one real-money investor (not showing in Figure 5).

Scope therefore believes that the Spanish economy can become a source of high quality SME securitisations even when higher-leveraged structures are used.

**Figure 5.** Spanish SME CLO issuance – retained vs. publicly issued



Source: JPMorgan.



# Spanish SME CLOs: Back in the Game

Special Report

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