

# Same Structures Different Collateral Risks Spanish SME CLOs



Scope  
Ratings

Scope rated all Spanish SME CLOs issued in 2015. In this report we provide a critical insight on the different types of collateral assets included in Spanish SME CLOs. We also explain how these assets' credit risk profile will shape how the transactions perform in 2016. Spanish SME CLOs issued in 2015 consisted of standardised structures, which at a first glance looked similar. However, the credit risk for these transactions lies in the peculiarities of their securitised assets, which comprises very diverse and sometimes non-standard debt products to SMEs.

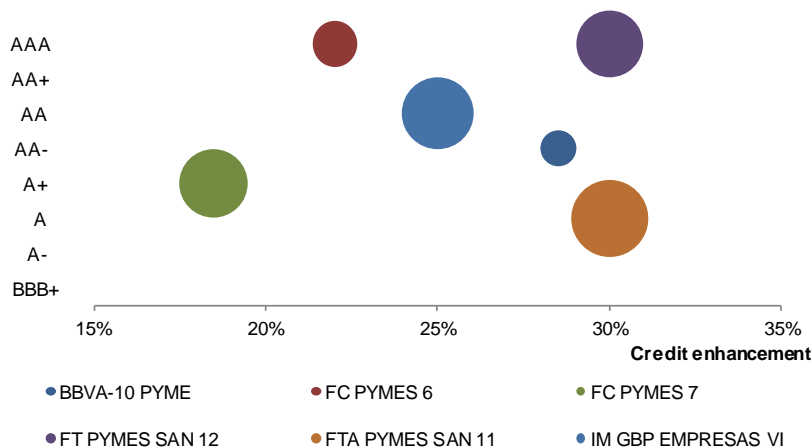
Scope expects the credit performance of SME CLO collateral to improve in 2016. Spanish GDP growth of above 2.5% in 2016 and rising bank lending competition will fuel high repayment rates as well as limit defaults. The senior tranches from all SME CLO transactions in 2015, with their relatively short lives, will therefore strongly benefit from how the collateral performs in 2016.

Scope has assigned ratings to the six SME CLO transactions issued in 2015 by Santander, BBVA, Caixa Bank and Banco Popular, at a total combined volume of EUR 14.1bn. Scope's credit risk assessment combines a view on structural credit enhancement in the transactions with a fundamental analysis of securitised assets in the context of the macroeconomic environment.

Scope expects SME CLOs in Spain to perform solidly in 2016. SMEs will benefit from the Spanish economy's growth at above 2.5% and from improving lending conditions. In the longer term, there is the risk of a negative impact on the Spanish economy, which is still pending reforms if Spanish political parties cannot form a stable and capable-to-act government.

Figure 1 shows the initial ratings Scope assigned to the senior notes of these transactions, which depend on the credit enhancement available to those senior notes.

**Figure 1. Spanish SME CLO initial senior ratings 2015<sup>1</sup>**



Source: Scope Ratings

## Analysts

**Sebastian Dietzsch**

+49 30 27891 252

[s.dietzsch@scoperatings.com](mailto:s.dietzsch@scoperatings.com)

**Carlos Terre**

+49 30 27891 242

[c.terre@scoperatings.com](mailto:c.terre@scoperatings.com)

**Guillaume Jolivet**

+49-30-27-891-241

[g.jolivet@scoperatings.com](mailto:g.jolivet@scoperatings.com)

## Related Research

'Spanish Banks' Capital Regime: More Clarity Entering 2016', January 2016

'Spanish SME CLOs: Forward to the Past', May 2015

## Scope Ratings AG

Lennéstraße 5

10785 Berlin

Phone +49 30 27891 0

Fax +49 30 27891 100

Service +49 30 27891 300

[info@scoperatings.com](mailto:info@scoperatings.com)

[www.scoperatings.com](http://www.scoperatings.com)



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<sup>1</sup> Bubble size represents the size of the senior tranches relative to each other.

### Wide variety of credit risk profiles for collateral assets

#### Focus on Spanish SME CLO collateral from 2015

The transactions presented to Scope in 2015 differed significantly with regard to collateral selection and types. Though structural mechanisms were similar with respect to liability costs, waterfalls, subordination and junior-tranche interest demotion, the credit risk profile of these transactions varied widely (see Figure 2).

**Figure 2. Transactions compared: Spanish SME CLOs in 2015 rated by Scope<sup>234</sup>**

	BBVA-10 PYME, FT	FONCAIXA PYMES 7	FONCAIXA PYMES 6, FT	IM GBP EMPRESAS VI, FTA	FT PYMES SANTANDER 12	FTA PYMES SANTANDER 11
Originator	BBVA	Caixa Bank	Caixa Bank	Banco Popular and Banco Pastor	Banco Santander, Banesto and BANIF	Banco Santander and Banesto
Closing date	15.12.2015	21.10.2015	26.06.2015	30.03.2015	02.12.2015	22.05.2015
Rating Senior tranche	AA <sub>-sf</sub>	A <sub>+</sub> <sub>sf</sub>	AAA <sub>sf</sub>	AA <sub>sf</sub>	AAA <sub>sf</sub>	A <sub>sf</sub>
Credit enhancement	28.5%	18.5%	22.0%	25.0%	30.0%	30.0%
Expected WAL	2.20	1.30	2.60	1.37	1.20	0.70
Coupon	3m-Euribor + 30 bps	3m-Euribor + 125 bps	3m-Euribor + 125 bps	3m-Euribor + 30 bps	3m-Euribor + 30 bps	3m-Euribor + 25 bps
Rating Mezzanine tranche	B <sub>+</sub> <sub>sf</sub>	CCC <sub>sf</sub>	B <sub>+</sub> <sub>sf</sub>	B <sub>+</sub> <sub>sf</sub>	B <sub>+</sub> <sub>sf</sub>	B <sub>-</sub> <sub>sf</sub>
Credit enhancement	5.0%	3.5%	4.0%	3.0%	5.0%	5.0%
Expected WAL	5.70	4.70	10.80	5.69	5.70	3.90
Coupon	3m-Euribor + 50 bps	3m-Euribor + 150 bps	3m-Euribor + 150 bps	3m-Euribor + 40 bps	3m-Euribor + 50 bps	3m-Euribor + 50 bps
Portfolio WAL	3.65	2.40	4.54	2.20	2.76	1.90
Portfolio coupon	2.6%	4.8%	2.8%	5.0%	2.6%	3.4%
Portfolio default rate	17.3%	9.8%	10.5%	6.2%	16.1%	13.9%
Default rate CoV	60.8%	55.0%	55.0%	70.0%	40.8%	61.0%
Portfolio cure rate	20.0%	10.0%	16.0%	15.0%	22.0%	15.0%
Portfolio recovery rate	50.9%	22.6%	40.0%	27.0%	33.0%	35.0%
Long-term-adjusted portfolio default rate	10.6%	5.0%	5.3%	5.3%	10.0%	9.2%
Long-term-adjusted default rate CoV	72.7%	74.0%	66.7%	80.2%	63.2%	80.0%
CPR - high case	16.0%	15.0%	15.0%	15.0%	12.0%	12.0%
CPR - low case	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Scope Ratings

The difference in credit risk profiles was driven largely by securitised assets. Besides standard SME loans and mortgages, portfolios securitised in 2015 contained flexible loans and mortgages, redrawable credit lines, debt-consolidation products, as well as 'non-conforming' mortgages (ineligible for Spanish mortgage covered bonds). Portfolio eligibility criteria generally resulted in positive selection for the securitised portfolios compared to the overall SME loan books of the originators, e.g. criteria excluded exposures over 30 days in arrears or exposures to real estate development.

<sup>2</sup>The junior tranche ratings for Santander transactions are not displayed.

<sup>3</sup>CE refers of the structural credit enhancement available to the particular tranche, excluding excess spread; CoV refers to the default rate volatility considered for the analysis of the particular portfolio.

<sup>4</sup>The derivation of the long-term-adjusted default rate and the corresponding CoV is explained in [Spanish SME CLOs: Forward to the Past](#), May 2015.

Figure 3 shows the different product types Scope identified in the portfolios, together with their risk-driving features and average modelling considerations.

**Figure 3. SME debt products in 2015 Spanish SME CLOs**

	Unsecured loans	Mortgages	Flexible mortgages	Debt-consolidation loan	Debt-consolidation mortgage	Credit lines
Typical obligor	Standard SME	Standard SME	Good quality SME	SME in distress	SME in distress	Standard SME
Product life (segment WAL)	3 to 4 years; up to 10 years	> 10 years	> 10 years	5 to 6 years; up to 10 years	> 15 years	< 1 year
Default risk	Medium, due to medium to long life and mixed obligor quality	Medium to high, due to long life and mixed obligor quality	Low to medium, due to long life, but good obligor quality	High, defaults almost certain; over product life	High, defaults almost certain over product life	Low, due to short life and continuous prolongation process
Default rate volatility <sup>5</sup> (CoV)	Medium (40% to 50%)	Medium (40% to 50%)	Medium (40% to 50%)	Low, due to almost certain default over time (below 20%)	Low, due to long risk horizon and almost certain default over time (below 20%)	High, due to short risk horizon and low seasoning (> 100%)
Expected cure rate	10% to 20%	20%	20%	0%, if in distress again, cure is unlikely	0%, if in distress again, cure is unlikely	20%
Expected base case recovery	20% to 30%	> 50%	> 50%	20% to 30%	20% to 30%	> 50%
Features	Amortising	Generally secured by residential; amortising; often high LTVs; grace periods	Redrawable, but predefined schedules	Generally amortising, but bullet exposures also common	Generally amortising, but bullet repayment possible; high LTV	Redrawable, even under default
Security	Personal or third party	First or second lien; residential or commercial	Personal or third party	Personal or third party	First or second lien; residential or commercial	Personal or third party
Additional transaction risks	Can contain obligors in arrears	Concentration risk for junior tranches; can contain obligors in arrears	Concentration risk for junior tranches	Can contain obligors in arrears	Concentration risk for junior tranches	Liquidity risk; revolving risk

Source: Scope Ratings

Scope's fundamental bottom-up analysis sheds light on the risk-driving features of every relevant debt product type in the portfolios. These features include: i) liquidity and revolving risk inherent in credit lines; ii) distressed collateral values in non-standard mortgages; iii) weak obligor exposures (i.e. principal in arrears); iv) distressed performance of debt-consolidation and refinancing exposures; and v) exposure to 'flexible' mortgages.

### Credit lines

Credit lines, to the extent they are not yet fully drawn, increase a transaction's exposure to risk and introduce liquidity risk for the structure, as drawings under those credit lines have to be serviced by the transaction. The revolving nature of the product can lead to 'balloon' risk, with higher default risk and substantial severity at maturity due to the refinancing risk under tail-risk scenarios.

### Credit and liquidity risk for transactions

<sup>5</sup> Default rate volatility refers to volatility found in default performance vintage data presented by the particular originator. Usually, default rate volatility reduces with an increase of the product seasoning, the considered risk horizon and the considered lifetime default rate.

Scope captures the additional risk with a higher portfolio default rate and a much higher default rate volatility (coefficient of variation, CoV). Arrangers address the liquidity risk by incorporating liquidity reserves that can be drawn, in case the portfolio cannot service the entire amount required for credit line drawings.

The very different sizes of the exposures to credit lines explains, among other factors, the variation in credit risk profiles of otherwise structurally identical transactions: FTA SANTANDER PYMES 11 and FT SANTANDER PYMES 12.

The portfolio balance of PYMES 11 comprised 40% of credit lines, which resulted in a coefficient of variation assumption of 61% (i.e. 50% higher than that of PYMES 12). The larger coefficient of variation reflects the higher probability of larger losses under tail-risk scenarios for the senior class.

Even so, the exposure to very short-life credit lines is less of an issue for junior tranches, as their expected good performance under current macroeconomic conditions is better than for average loans. Fast amortisation also helps the senior classes.

#### High LTVs and long maturities

##### Non-conforming mortgages

Non-conforming mortgages have high loan-to-values (LTV)<sup>6</sup>. These are often granted to weak obligors and incorporate significant grace periods, meaning they do not conform as covered bonds eligibility standards. In addition, these mortgages often have very long maturities of up to 40 years, which result in high contributions to portfolio lifetime default rates. Recovery rates are also 'depressed' due to the generally weaker profile of obligors as well as high LTVs.

Arrangers addressed these exposures by increasing the structural credit enhancement for the senior tranches in order to absorb losses. Given the long maturity profile of non-conforming mortgages, their credit risk contribution is often borne by mezzanine and junior tranches, which are strictly subordinated to the senior tranche. Most transactions also incorporate interest-demotion mechanisms on non-senior tranches, which increases the portfolio excess spread available to protect senior tranches.

Scope's analysis reflects both the structural credit enhancement for senior tranches, which addresses its high contribution to portfolio lifetime default rates, and the lower recovery rates from mortgages in Spanish SME CLO portfolios.

##### Most transactions include weak obligors

Weak obligors, sometimes delinquent, were found in most SME CLO portfolios in 2015. Delinquencies of up to 'a few days' can be due to payment-related technicalities, but can also indicate an exposure to weak obligors.

#### Weak obligor exposure increases default estimates

Scope considered the exposure to obligors in arrears beyond a certain threshold as indicative of weak obligor exposure, which results in an upward adjustment of portfolio default rate assumptions, e.g. in IM GBP EMPRESAS VI, FTA

##### Debt-restructuring loans

Debt-restructuring exposures relate to products granted to obligors which consolidate credit obligations into one exposure with more convenient terms. These obligors have not defaulted, but have been close to distress. The historical performance of these exposures has been very weak, with almost certain default over the lifetime of the exposure.

In 2015 only two Santander transactions, PYMES 11 and PYMES 12, securitised debt-restructuring loans. PYMES 12's higher exposure to these weak obligors is a major reason we assumed comparable portfolio default rates for both deals. The portfolio of PYMES 12 is better than that of PYMES 11, considering average asset quality based on

<sup>6</sup> Securitised mortgages showed LTVs in excess of the limits on Spanish mortgage-covered bond: 80% for residential properties and 60% for commercial properties.

### Lower recoveries for the transaction upon default

internal probabilities of default (PD) assigned by the bank to each loan (i.e. weighted average PD of 5.6% for PYMES 11 vs. 3.3% for PYMES 12). Yet, PYMES 12 securitises twice as many debt-restructuring loans (unsecured loans and mortgages) as PYMES 11.

### Flexible mortgages

Flexible mortgages enable the obligor to draw additional debt under the same contract, limited by a maximum LTV covenant, which then ranks pari-passu with pre-existing obligations. The debt burden for the obligor increases on the same seniority level, which is a credit-negative when assessing expected recoveries on the instrument upon default.

FC PYMES 6 and FC PYMES 7 are exposed to flexible mortgages, which is especially important for FC PYMES 6 as 22.5% of its portfolio comprises flexible mortgages. The recovery rate on the 67.3% mortgage share considered in this transaction reflects an LTV of 55%<sup>7</sup>, which is adjusted upwards for the entire exposure associated with individual flexible mortgage contracts. To just consider each contract's securitised portion would result in an average LTV of 10%, inadequate for assessing recovery proceeds available to the transaction upon a default.

### Economic outlook and bank lending environment positive for 2016

### The Spanish SME sector in 2016

The economic outlook for Spain is positive and suggests improving performance for Spanish SME CLO collateral<sup>8</sup>. A second positive driver of Spanish SME performance is the supportive banking environment in 2016. Higher competition among lenders will result in better access to credit, further improving conditions for company financing.

Beyond two years, the picture is less certain, as fundamental imbalances of the Spanish economy must be tackled to maintain the path to recovery. Long-term uncertainties on the Spanish economy may significantly affect the performance of long-duration assets, such as unsecured loans with bullet amortisation or long-maturity amortising mortgages.

### Spanish economy in 2016

Spanish GDP growth of about 3.2% in 2015 (1.6% for the eurozone) was fuelled by private consumption. The consensus outlook for 2016 sees continuing economic recovery, with GDP growing at 2.7%<sup>9</sup> based on the same fundamentals. This economic recovery has started to reflect positively on the unemployment rate, reducing to 21.2% (Q3 2015), a level not seen since Q2 2011.

### Growth estimate for 2016 depends on reform continuation

The 2016 consensus growth estimate depends heavily on the assumption that Spain remains on its market reform path, which aims to improve the country's economic competitiveness and unemployment rate, and achieve fiscal consolidation.

In Scope's view, the current political situation in Spain is challenging, which can potentially jeopardise reform achievements to date and slow down the economic recovery in 2016. Since the December 2015 elections, there is no stable majority in the Spanish parliament, and no new government has yet been formed. The conservative ruling party that started the reform process lost its mandate, with its leader declining to form a coalition. In the end, the king had to appoint the socialist candidate in order to form a coalition.

Forming a coalition has been difficult owing to pressures from the political 'left'. Radical parties openly challenge current reforms, and stable coalitions forming a strong majority are unlikely at present. Given this environment, there is risk that the economic recovery in Spain could be negatively affected, resulting in slower GDP growth and a protraction of high unemployment rates in 2016.

<sup>7</sup> The base case recovery rate of 67.3% uses the 55% LTV as a starting point, but incorporates indexation, foreclosure costs and fire-sale discounts.

<sup>8</sup> More than 90% of the country's businesses belong to the SME sector.

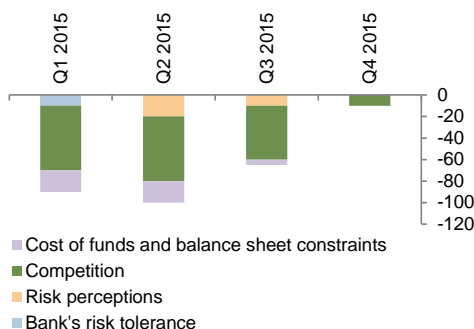
<sup>9</sup> Consensus estimate in line with GDP growth of 3.1% in 2015.

### Bank lending to SMEs and Spanish SME CLO market in 2016

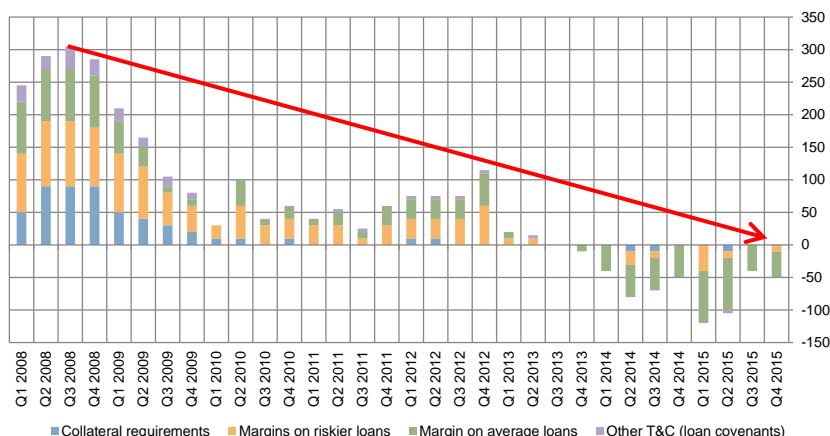
In 2016, SMEs will benefit from better financing conditions. Spanish banks focus their lending activity largely on the SME sector. Higher competition results in lower lending standards (see Figure 4 and Figure 5), supported by the strong capital position of Spanish banks as highlighted in Scope's banking research: 'Spanish Banks' Capital Regime: More Clarity Entering 2016'.

Moreover, banks often adjust debt products to fit individual borrowers' needs, which can generally result in very flexible debt with lower interest margins and longer maturities.

**Figure 4. Supply factor drivers**



**Figure 5. Supply factors, i.e. bank lending conditions**



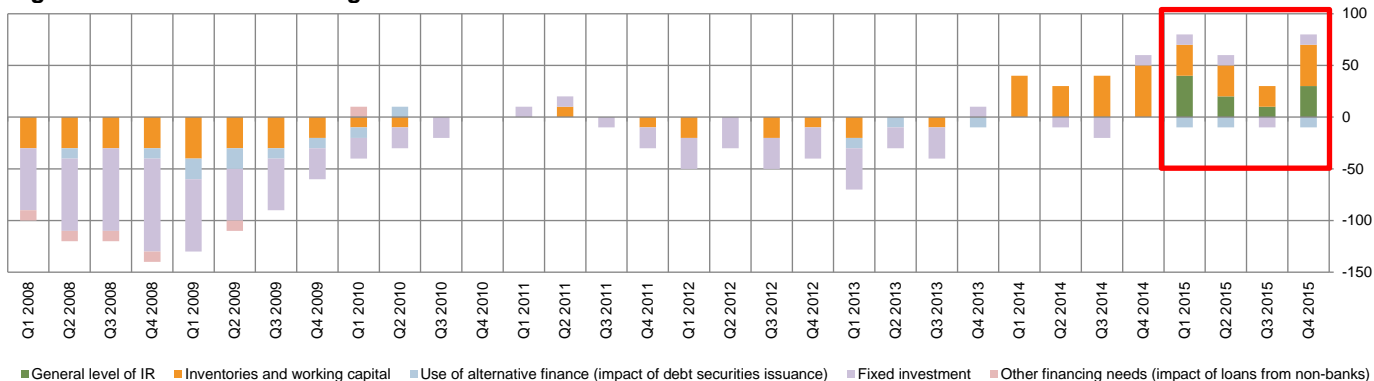
Source: Scope Ratings, ECB

Regarding the SME CLO market, this banking environment is credit-positive for the performance of existing Spanish SME CLOs, whose portfolios will amortise fast in 2016 due to high repayments.<sup>10</sup> Moreover, good borrowing conditions will reduce the financial pressure on obligors as well as limit defaults.

### Low interest rates drive borrower demand

The latest ECB bank lending survey shows that obligors seek to replace higher interest debt, benefitting from improving offers by banks (see Figure 6: a main driver of demand in 2015 was the general level of interest rates). Even riskier SME sectors, like Spanish real estate development, might benefit from bank lending competition, as banks try to increase their market share (see Figure 5: margins on riskier loans even improved).

**Figure 6. Drivers of borrowing demand**



Note: Figure 4, Figure 5 and Figure 6 represent net percentages of responses; negative numbers in Figure 4 and Figure 5 have to be interpreted as either supporting easier lending standards (Figure 4), or a net easing of lending standards (Figure 5); positive numbers in Figure 6 have to be interpreted as positive demand for borrowing

Source: Scope Ratings, ECB

<sup>10</sup> Some transactions in 2015 showed prepayment rates of 10% to 20%, fuelled by good refinancing opportunities.



## Same Structures Different Collateral Risks

### Spanish SME CLOs

The improved capital situation of Spanish banks has enabled more competition, as banks are well placed to maintain adequate capital buffers, allowing them to expand lending and further increase their risk appetite. This continues the trend from Q4 2013, a period characterised by easing lending standards and increasing borrowing demand (see Figure 5 and Figure 6).

#### First truly post-crisis SME CLOs expected

Spanish bank lending appetite may therefore help further issuance of SME CLOs in 2016 from the same group of issuers as in 2015. The refinancing, truly post-crisis, debt directly fuels new securitisations, which will generally be retained as we expect the ECB repo program to continue through 2016. Spanish banks will securitise the newly granted SME debt to benefit from the ECB funding program<sup>11</sup>. Scope expects the market will still be driven by retained transactions, as the ECB repo-option results in yields, which do not reflect the risk inherent in the transactions.

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<sup>11</sup> The ECB repo lending rate of 0.05% is still effective since September 2014.



## Same Structures Different Collateral Risks

### Spanish SME CLOs

#### Scope Ratings AG

##### Headquarters Berlin

Lennéstraße 5  
D-10785 Berlin

Phone +49 30 27891 0

##### London

Suite 407  
2 Angel Square  
London EC1V 1NY

Phone +44 20 3457 0444

##### Frankfurt am Main

Rüsterstraße 1  
D-60325 Frankfurt

Phone +49 69 97944 754

##### Madrid

Paseo de la Castellana 95  
Edificio Torre Europa  
E-28046 Madrid

Phone +34 914 186 973

##### Paris

21, Boulevard Haussmann  
F-75009 Paris

Phone +33 1 53 43 29 89

[info@scoperatings.com](mailto:info@scoperatings.com)

[www.scoperatings.com](http://www.scoperatings.com)

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