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Outlook 2015

Structured Finance & Covered Bond

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The ECB ABS and covered bond purchase programme could disguise credit differences in Europe

The ECB demand translates into spread compression on ABS and reduces the spreads of covered bonds to below pre-crisis levels across all European countries. Scope Ratings expects that the low spreads will partially mask the different credit risk levels of the individual issuances.

Scope Ratings sees much wider differentiation of credit risks than the credit spreads would indicate. Investors will therefore need more transparency and information to take investment decisions. This will be a key theme for both the securitisation and covered bond markets in 2015.

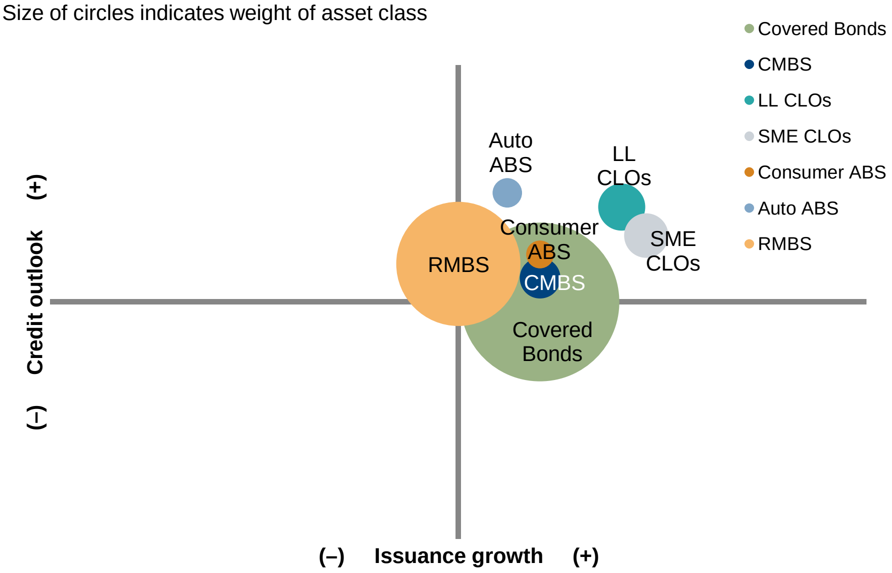
ECB-driven spread compression of European securitisations creates technical conditions supporting issuance volumes of SME CLOs in particular. Low spreads also make securitisations a viable tool for the optimisation of banks' balance sheets via regulatory risk transfer. For leveraged loan CLOs, it may also drive structural innovation and the resurgence of multi-currency transactions.

The credit outlook for European structured finance and covered bonds is positive in 2015. The performance of most asset classes will be supported by low interest rates, improving refinancing and credit availability and modest economic growth in the European Union. However, spread compression may erode general risk awareness, making it more difficult for investors to discriminate between transactions.

Scope´s 2015 Credit Outlook for European structured finance and covered bonds is summarised in Figure 1 and the associated table below.

Figure 1 Structured finance & covered bonds 2015 credit outlook diagram

Size of circles indicates weight of asset class



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Asset class	Credit factors	Trend	Credit impact
SME CLOs	GDP growth	Stable/Increasing	Stable/Positive
	Bank financing availability	Improving	Positive
	Unemployment	Stable/Improving (*)	Stable/Positive
LL CLOs	Low interest rates	Stable	Positive
	Collateral prepayments	High	Positive
	Corporate ability to refinance	Stable/Improving	Positive
Covered Bonds	Regulatory developments	Supportive	Positive
	Bank rating migration	Stable/Positive	Positive
	Covered Bond specific risks	Uncertain	Negative
General Consumer ABS, including RMBS	GDP growth	Stable/Increasing	Stable/Positive
	Low interest rates	Stable	Positive
	Unemployment	Positive	Positive
	Tax pressure	Stable/Increasing	Negative
CMBS	Yield evolution	(Country specific)	(Country specific)
	Refinancing availability	Stable/Positive	Positive
	Low interest rates	Stable/Positive	Positive

(*) Except for France, according to IMF forecasts for 2012.

Introduction

Structured finance issuance will increase in 2015

Scope expects an increase in the aggregate issuance volumes of European structured finance transactions in 2015 after a continuous nosedive since 2008. The increase will largely be driven by political decisions. Government initiatives and central bank intervention are fuelling lending growth in the context of a modest improvement of the macro economic situation in major European countries. We therefore expect securitization to resume on a larger scale, probably focusing on business loan collateral rather than on mortgages as was the case before the crisis. The ECB's ABS purchase program (ABSPP) represents a powerful attraction for new securitization deals, which should materialise in 2015.

Market technicals for covered bonds are also very favourable with spreads below pre-crisis levels. We expect low spreads for covered bonds to help a funding rebound in the European economies, but they will also partly mask the prevailing differences in credit risk between different covered bond issuers. Additional transparency will therefore remain crucial for investors to take adequate investment decisions – a key theme for both the securitisation and covered bond market in 2015.

Scope expects SME CLOs to be one of the main asset classes to grow in 2015 and they should contribute to European structured finance issuance volume growth, along with Auto ABS and UK RMBS, which were already active in 2014. However we do not expect the ABSPP to significantly distort the securitisation issuance mix, which will continue to be RMBS, Auto ABS and SME CLOs. Banks have probably postponed the issuance of transactions pending further clarification regarding the implementation of the ABSPP, which could explain part of the slump in issuance volumes in Q3 2014, down 64.1% to EUR 35.7bn from EUR 99.5bn in Q2 2014. Leveraged loan CLO issuances will also contribute further to volume growth, supported by positive market technicals for the asset class and a stable performance credit outlook for the underlying assets.

The ECB defines the future of European securitisation

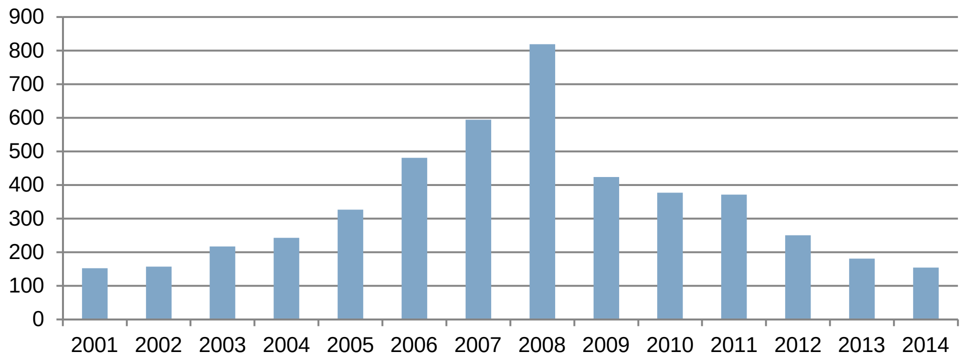
The ECB's covered bond and ABS purchase programme (CBPP and ABSPP) will determine the dynamics of European securitisation in 2015. The commitment of the ECB to invest in European securitisations reinforces the sector's credibility. This is necessary after the American subprime crisis unjustly damaged the reputation of securitisations in Europe among some investors.

CBPP and ABSPP seek to increase issuance volumes as policymakers see securitisation as a useful tool for promoting a broad economic recovery across Europe. CBPP and ABSPP will nevertheless contribute to a compression of spreads for eligible assets and potentially other structured finance products as a result of a spread tightening contagion effect.

The increase in demand for ABS and the associated prices compression could also result in crowd real money investors out of certain asset classes. Investors in search for yields may have to transition toward riskier investments. The increase in ABS demand may also initiate the return of more aggressive origination standards.

European securitisation issuance volumes remained modest in 2014 and were driven by regulatory and funding transactions. ABS issuance over the first three quarters came to EUR 154.8bn versus EUR 180.3bn for full-year 2013 (see Figure 2 and Figure 3). The European structured finance markets have contracted since 2008 when volumes were EUR 819bn. Securitisations have been largely retained by banks to serve as repo collateral with the ECB and only EUR 52bn were placed with real money investors in 2014 to date.[1]

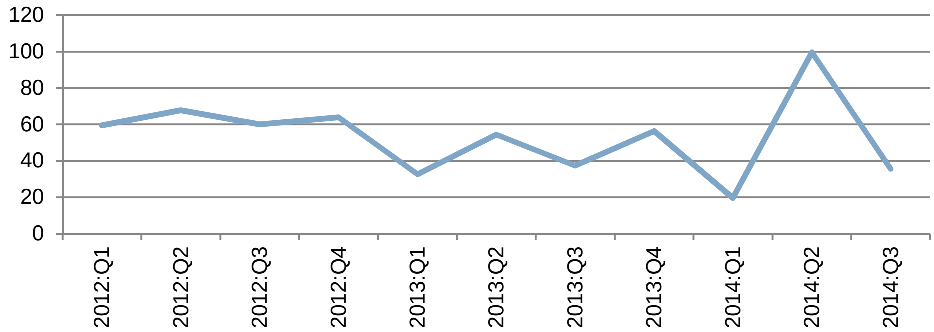
Figure 2 Historical European ABS issuance (EURbn)



Source: AFME

[1] Source Bloomberg, AFME

Figure 3 Quarterly European ABS issuance (EURbn)



Source: AFME

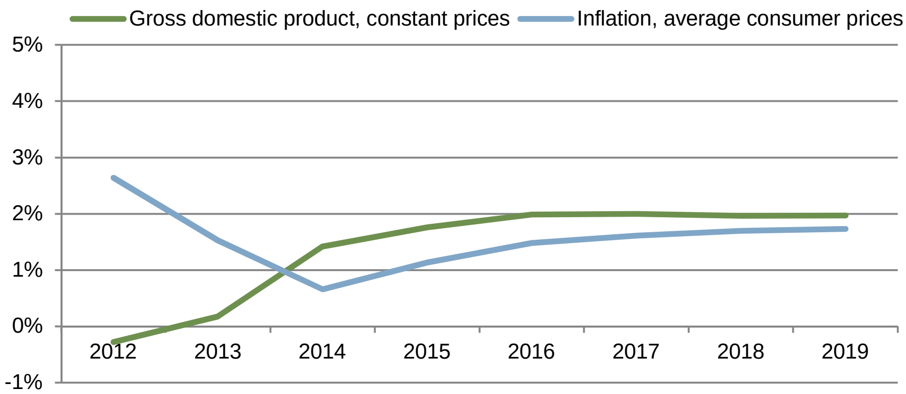
Limited economic recovery to support issuance increase in 2015

The macro-economic recovery in Europe remains slow and driven to a great extent by central bank support. We nevertheless believe that the now stronger banking systems will play a key role in funding the recovery. The systemic stress among euro area banks and sovereigns has declined to the lowest levels since the global financial crisis in 2007, according to the latest Financial Stability Review of the European Central Bank.

The credit performance of existing securitisation transactions and the issuance volume will benefit from the slow economic recovery expected in Europe in 2015. The economic context in the European Union appears favourable for structured finance with a GDP forecast of 1.8% versus 1.5% in 2014 according to the IMF (see Figure 4).

Consumer fundamentals will continue to improve, particularly in peripheral Europe in a low interest-rate environment. Unemployment rates forecasts by the IMF point to a decrease in all major European countries in 2015, with the exception of France.

Figure 4 GDP and inflation forecasts for Europe



Source: IMF, latest forecast after 2013

Banks' appetite and incentives to issue securitisations

The ECB-driven spread compression on European securitisations could make securitisations an attractive tool for the optimisation of banks' balance sheets via regulatory risk transfer. Banks will originate loans but remove part of the risks from their balance sheet through securitisation techniques, thus achieving more favourable regulatory capital charges. For a discussion on this topic please refer to Scope´s 2015 Bank Outlook: ***European Banks through New Eyes: An Outlook for 2015 and***

Beyond published Dec. 2, 2015.

At the same time, investor confidence is gradually and selectively recovering and investors are looking for new sources of yield. Consequently, banks will probably explore the application of structured finance techniques to less conventional assets such as aircraft leases, shipping and project finance or infrastructure securitisations in order to address investor demand.

Covered bond outlook 2015

Too little supply for too many investors could erode risk awareness!

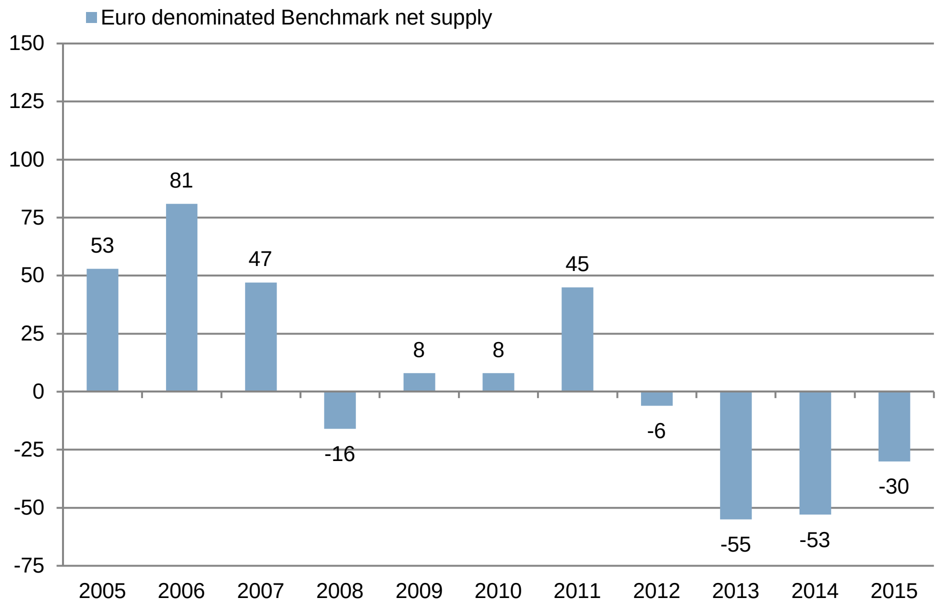
We expect covered bond issuance to sustain a strong momentum in 2015 – comparable to 2014 – even though this might not necessarily translate into further growth for the asset class. However, the high attention to the asset class will remain.

Demand for covered bonds remained at record high levels in 2014, translating into a spread compression across all European countries. In our view this reduces the willingness of investors to contrast and compare the risks they are exposed to. In response to the spread compression, investors actually favour covered bonds trading at the highest spreads which, if spreads are an indicator of risk, are the most risky. Since covered bonds are once again increasingly being viewed as a "rate" product, credit considerations receive lower attention than during the financial crisis. We believe that from a rating perspective, investors should remain selective in their investments because underlying credit risk and risk tiering will be hidden by a technical supply/demand imbalance.

Reduced spread differentiation reflects a continued supply/demand imbalance and not a lower risk level

Covered bond benchmark redemption volumes continued to be higher than new issuance in the European covered bond market. The net negative supply in 2014 was about EUR 53bn and is likely to remain negative in 2015.

Figure 5 Annual net supply of benchmark covered bonds (EURbn)



Source: Barclays Research

Investor demand remains high as existing investors want to reinvest their holdings in the product. At the same time, new entrants also want a share of the market. The European Central Bank (ECB), for example, uses covered bonds to enhance the transmission of monetary policy. In October it set up its third covered bond purchase program (CBPP3) to support liquidity for banks and create a stimulus for the economy. As of 5 December 2014, banks have already siphoned about EUR 21bn from the market, and for some new issuances, central bank participations have exceeded 60%, effectively crowding out real money investors. We further understand that more European banks have become active as they want to resort more to covered bonds to manage their liquidity ratios (LCR), at the same time as supply remains subdued.

Covered bond funding currently not needed?

In our view, the scarcity of new mortgage collateral and the availability of other funding sources are currently the main reasons for the limited covered bond supply. Banks have readjusted their business models, and the competitive funding advantage of covered bonds versus senior unsecured funding is at low absolute levels – ultimately prompting banks to issue unsecured debt rather than covered bonds. Furthermore, covered bond issuers still need to adjust their balance sheets. Regulators also pay a lot attention to banks improving their capital buffers and we expect issuance of AT1 and similar capital instruments to surge (see Scope's report: ***European Banks through New Eyes: An Outlook for 2015 and Beyond*** published Dec. 2, 2015). On October 9, Scope published a comprehensive report including first-time ratings for more than 45 capital instruments of 11 banks in six EU countries and in Switzerland. However, the additional capital also provides banks with funding that needs to be deployed, ultimately reducing the incentive to issue covered bonds. While going forward issuance of new capital instruments is one way to adjust capital ratios, another one will be the further shrinking of balance sheets and thus a continued deleveraging.

Limited growth in Europe not likely to provide new collateral to support issuance

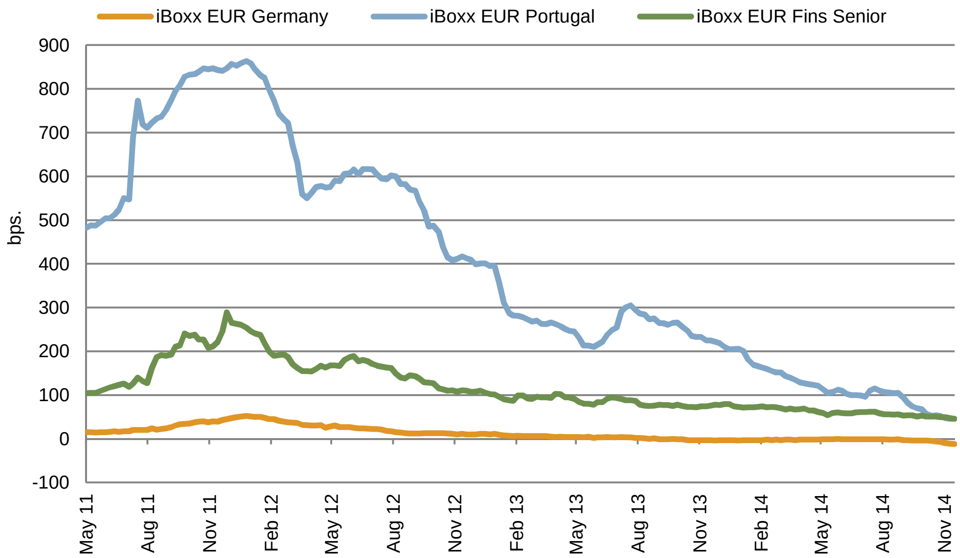
Ongoing high public sector deficits might speak for a resurgence of public sector covered bonds but their share has actually shrunk to below 20% in 2014 from almost 60% in 2004. This reflects not only the almost inexistent or even negative margins for public sector lending but also changed risk weightings and imposed leverage guidelines.

Issuance of mortgage covered bonds has benefitted from that shift and now makes up the vast majority of outstanding covered bonds. However, issuance here is lower than in the past as well. Following the emergence of Belgian "pandbrieven" in 2012 no larger European country can provide additional sizeable covered bond volumes to support growth. Also, housing prices have bottomed out in most countries and we continue to observe meagre growth at best in new mortgage lending across most of Europe. This also translates into lower funding needs for the banks. Since under the current monetary policy banks have almost unlimited access to extremely cheap funding in absolute terms, we do not expect covered bond issuance to increase significantly or the imbalances to cease in the short term.

Pre-crisis spread differentials but a wider credit spectrum.

At the end of 2011 the view that covered bonds are a low credit risk asset class was supported by very high ratings, and no covered bonds were rated below investment grade. Spread differentiation was significant, however. The differential between IBoxx covered bond indices for Portugal and Germany, for example, was at a whopping 800 bps. Today, the spread differentials between the same countries have contracted significantly and were a mere 60bps at the end of November 2014.

Figure 6 Development of selected covered bond and bank spreads
% iBoxx covered bond spreads



Source: J.P. Morgan International ABS & CB Research

Have covered bond ratings reflected this? With the emergence of the bank resolution and recovery frameworks, implicit government support can no longer be taken for granted and the bail-in or the ability to restructure a bank without taxpayers sharing the burden will become the "new normal". Banks are operating in a more challenging environment and the anchor point for the covered bond rating, the ratings of the issuers, are now lower than before. While some covered bonds have also experienced negative rating migration, the average covered bond rating remained on average almost at the previous level. Averages can obfuscate, however. Covered bond ratings today span a much wider range and, at B+, the lowest covered bond ratings remain well below investment grade, indicating that higher scrutiny and differentiation is warranted.

Have the credit risks for covered bonds reduced as significantly as the spread compression might indicate?

The first recourse of a covered bond investor to the bank has become more robust since the crisis. The various monetary operations of the ECB eased liquidity problems, and the ECB's "stress test" has shown that banks have become more resilient. Furthermore, the BRRD will lead to increased capitalisations, which will effectively reduce the likelihood that a covered bond will need to rely on the second recourse, the cover pool.

From a rating perspective, the risks on the assets we see in cover pools as well as the refinancing risks and their corresponding mitigants continue to differ significantly between various European countries and their cover pools. We see a much wider differentiation of credit risks than the credit spreads might indicate. Given the current trend for longer maturities in recently issued covered bonds, investors should therefore carefully assess the current and expected composition of cover pool risks. Should liquidity become more constrained than today, investors might need to revisit the cover pool. However, they may face a wakeup call as they will then not be compensated for changes in the risk profile of the covered bonds they are invested in on the long run.

Transparency needs to improve further

Industry efforts such as the “Label Initiative” of the European Covered Bond Council (ECBC) and regulatory requirements for covered bonds in the Capital Requirement Directive (CRD IV, in particular the CRR) have prompted issuers to provide more information on the status quo of cover pool risks. Forward-looking statements from covered bond issuers on the development of cover pool risks remain rare, however. Already prior to the start of the CBPP3, the European Covered Bond Investor Council (CIBC) stated in a study that they observe a “changing balance of power” from investors to issuers when it comes to providing a sufficient level of transparency. In the current environment of oversubscribed issuances this development is becoming even more exacerbated.

We believe that despite the current favourable environment investors should continue to ask for more forward-looking statements by the issuers in order to form a valid credit opinion on their long-term investments. This is also important for covered bond ratings as the potential volatility of the collateral composition and their corresponding mitigants form an important part of the covered bond credit risk evaluation process. Investors can only evaluate the longer term risks they have bought into through a holistic and balanced analysis of the various risks a covered bond is exposed to over time.

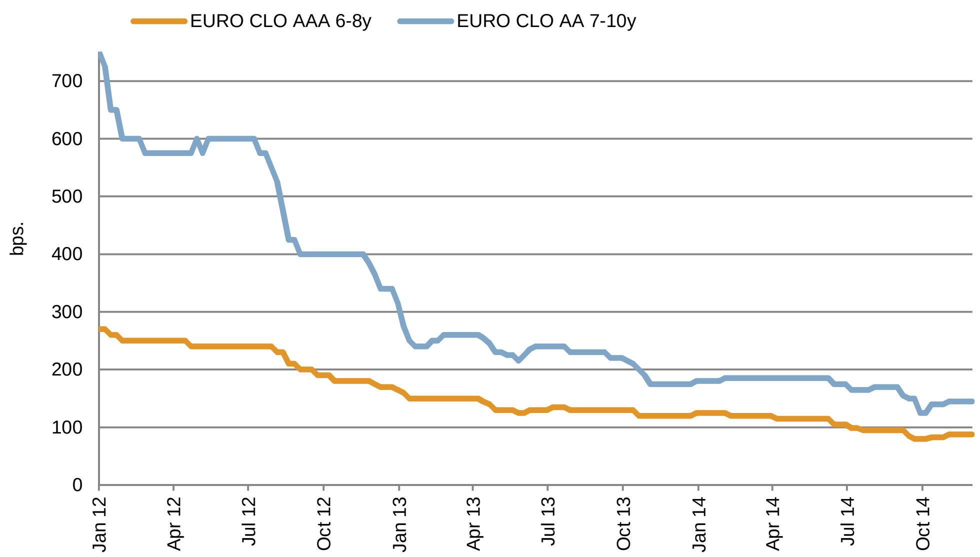
European Leveraged Loan CLOs: Key Themes in 2015

Current technicals and the economic backdrop support a volume increase

Scope expects European CLO issuance volumes to maintain their momentum in 2015 and to exceed the EUR 15bn mark, which will probably be reached in 2014 (EUR 13.6bn issued by November 2014). Issuance volume will be driven by the factors described below.

First, the issuance of European CLOs should continue to benefit from liability costs, which are at attractive levels for issuers 2015. This situation stems from the substantial demand for 122a[2] compliant transactions and the limited supply of European CLOs, which created a supply/demand imbalance in Europe. The ECB´s ABSPP may also reinforce by contagion the spread tightening trend of European CLOs in 2015, although the asset class is not eligible for this program. Despite a recent uptick as this report goes to press, the secondary spreads on European CLOs have tightened significantly across the entire capital structure over 2014. Compared with the highest levels observed over the year, secondary spreads shrank to 85bp from 125bp for the AAA as at 4 December 2014. At the moment, spreads for AAA European CLO tranches are therefore substantially tighter than those of AAA US CLO tranches, currently at 95bp.[3]

Figure 7 European CLO spread development



Source: J.P. Morgan International ABS & CB Research

Second, European CLO issuances will benefit from the expected stable credit performance of underlying collateral, driven by stable, low interest rates and favourable refinancing conditions in 2015.

[2] The risk retention rule applied to EU securitisation formerly known as 122a has now been replaced by the Capital Requirements Regulation (CRR), which came into force on 1 January 2014. This rule requires securitisation investors to invest in transactions where the 'sponsor', must explicitly disclose that it will retain, on an ongoing basis, a minimum 5% net economic interest in that securitisation. For CLOs, the sponsor designates the CLO Manager.

[3] Source Bloomberg Financial Markets, Morgan Stanley, J.P. Morgan.

Multi-currency CLOs issuance to reappear

We expect a resurgence of multi-currency CLO's in 2015 because asset managers will increasingly consider the diversification benefits of including foreign currency loans in their portfolios, particularly USD and GPB assets. The European leveraged loan market does not offer a sufficient loan supply and European CLO managers currently face the challenge of building sufficiently diversified portfolios both in terms of obligor and industry. In addition, they may have to look for more loan collateral for transactions that aim to fulfil one of the requirements of Volker rule in order to comply with the investment constraints of US Bank investors.[4] CLOs including multi-currency assets allow managers to build more diversified and credit-wise robust portfolios. Natural hedging of FX risk through multi-currency liability structures will be preferred over asset swaps. This is because asset swaps are often not a viable option due to their high costs and the scarcity of suitable hedging counterparties.

To date, managers and arrangers have not been willing to work with multi-currency structures, because such structures limit the amount of leverage a CLO can sustain. This is because i) hedging strategies create additional costs to the structure; ii) complexity deters investors; and iii) hedging requires more engineering and entails constraints for the parties. However, the costs of European CLO structures have reached levels which may re-activate appetite for and justify the issuance of multi-currency CLOs in 2015.

Bank-affiliated managers and large US managers may enter the market

The risk retention rule applicable to most European CLO investors (initially Article 122a of the Directive 2006/48/EC)[5] imposes a number of constraints on CLO managers. Management firms that decide to (re)enter the European CLO market must take a strategic step and commit long-term capital to the CLO management business.

Scope believes that a few managers may take such steps in 2015. In particular, Scope expects that CLO managers affiliated to banking groups, with the ability to comply with the European risk retention rule framework, will try to enter the post-crisis CLO market in 2015. European managers affiliated to banks such as BNP Paribas, Natixis, or IKB have not issued CLO2.0 to date. Similarly, as seen in 2014 with Sankaty or more recently Halcyon issuing transactions in Europe, additional US-based CLO managers may enter the European CLO market in 2015 to leverage the scalability of their credit platforms.

The risk retention applied to European investors has constrained the amount of CLO transactions available to them with suitable eligibility characteristics. The current demand from European investors may therefore encourage some US CLO managers to issue US CLO transactions complying with the constraints applied to investors under European regulation. European investors will possibly be attracted by the higher spread currently offered across the capital structure of US transactions.

[4] Among other constraints, the Volcker rule specifies that CLOs or CLO3.0s, must only invest in loan securities and not bonds.

[5] See footnote 6.

Peripheral SME CLO outlook – example of Spain

SME CLOs are seen as the white knight that could help Europe recover[6]. Indeed, SMEs represent more than 95% of the total number of enterprises in all European countries. Promotional lending to European SMEs will continue to be a major objective across the Eurozone. However, at the moment, the SME sector across Europe suffers from relatively limited and expensive access to credit. Figure 8 indicates rising spread levels over bank refinancing reference rates, post-crisis.

The outlook for SME CLO securitisations in peripheral countries can be illustrated with the Spanish case. Volume will grow and credit performance will benefit from the fragile but positive economic growth anticipated in most European countries in 2015.

Lending to SMEs can be constrained by lenders' underwriting standards and the lack of credit demand from good quality borrowers. However, the modest economic growth in 2015 may also support the availability of quality SME creditors that has constrained the production of loans for securitisation to date.

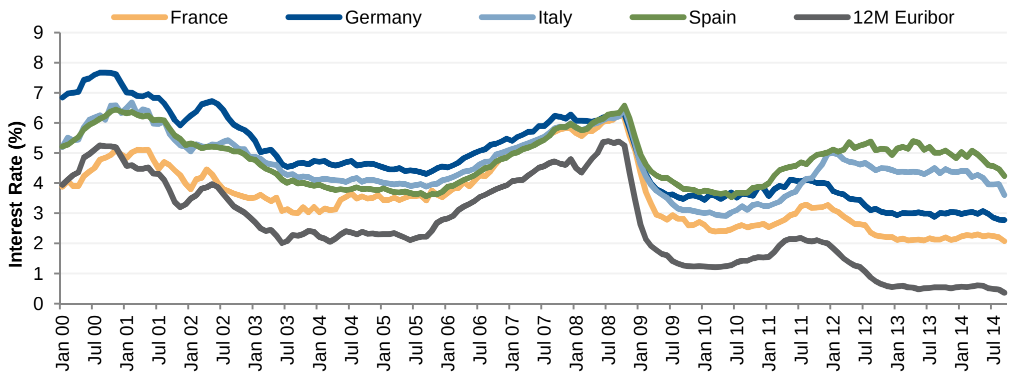
Potential for Increased Issuance Volume

The ABSPP initiative from the ECB will contribute to lower the cost of funding for SME CLOs. Scope believes that such lower cost of funding, combined with more favourable conditions for banks to issue new loans, will support the increase in SME CLOs volumes, particularly from peripheral countries such as Spain.

Promotional lenders will focus on securitisation as a tool to fund the real economy, largely represented by SMEs. This is because the post-crisis regulatory environment in Europe imposes strict capital charges, as well as leverage and liquidity restrictions on banks. These restrictions would otherwise constrain SME lending.

The substantial excess spread available in SME securitizations should have a positive effect on securitisation issuance in 2015. The cost of funding for Spanish and Italian SMEs has experienced a shift whereby their link with official rates broke after 2009. Borrowing costs for SMEs in peripheral countries remain high, while SME CLO securitisation funding costs trend downward.

Figure 8 Interest rates for SME lending no longer follow official rates



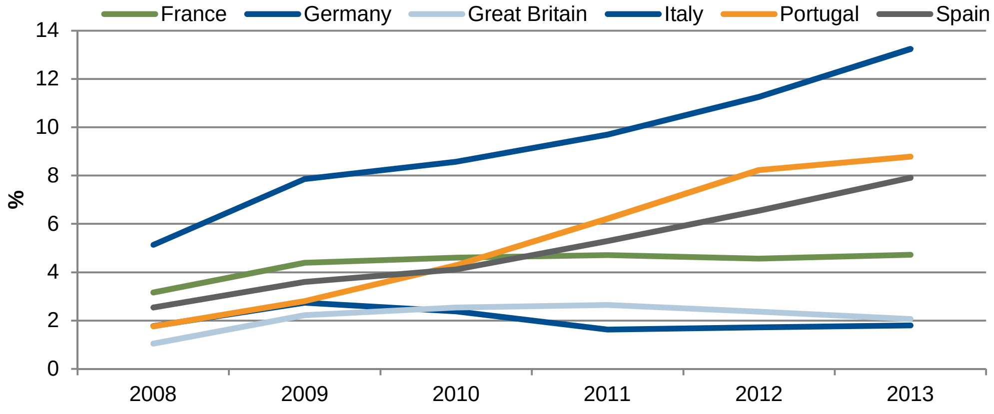
Source: ECB

[6] "SME Loan Securitisation 2.0 Market Assessment and Policy Options", Working Paper 2013/19, EIF Research & Market Analysis, European Investment Fund.

The higher rates for existing loans are driven by the banks. Borrowing costs discount a recessionary scenario that today appears less certain as Europe experiences a timid recovery. The development in interest rates offered by banks to Spanish SMEs also reflects the impact of Euribor levels.

Figure 9 shows that Italian, Portuguese and Spanish SME debt has followed a similar credit quality deterioration path. Germany and the UK proved resilient during this period of stress and France has experienced steady delinquency levels, which are substantially higher than those of Germany and UK.

Figure 9 Gross total doubtful and non-performing loans across Europe
% of total debt instruments and total loans and advances



Source: ECB

Note: Gross total doubtful and non-performing loans of domestic banking groups and stand-alone banks

Spanish recovery

Scope believes that the performance of SME CLO securitizations will not deteriorate in 2015 and may even improve. This is because SMEs will benefit from slow but positive economic growth and better access to credit in 2015. In addition, Scope expects that the performance of new Spanish SME CLO securitisations will not be determined by the performance of real estate and construction because new lending in these sectors will be scarce, with strong underwriting scrutiny.

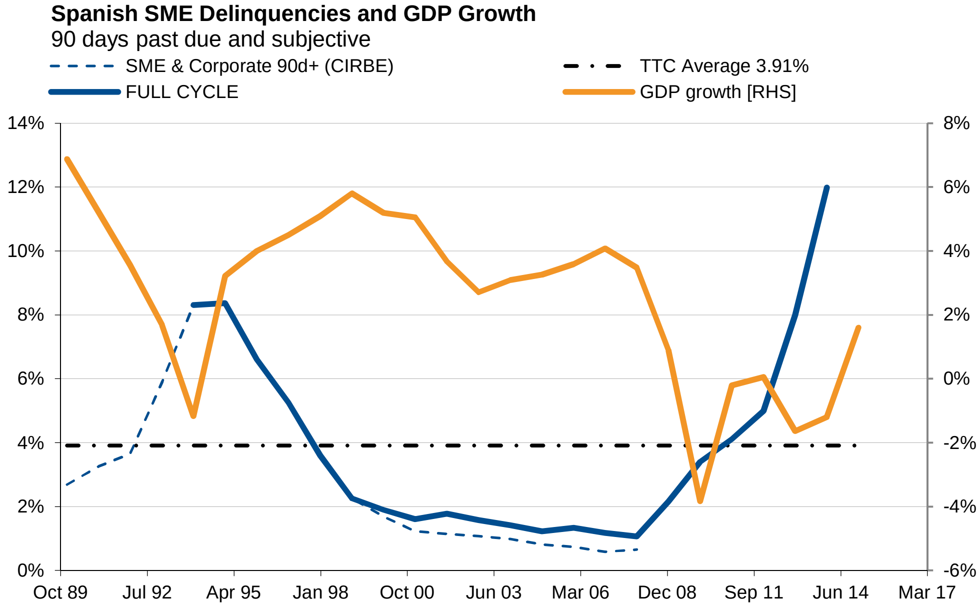
Economic growth and delinquency rates

Scope believes that the trend in Spanish SME delinquency rates could change sharply in 2015 as GDP growth crosses the 2% threshold. The credit performance and default rate of SME loans is highly sensitive to the general economic growth. The 2% GDP growth level has traditionally been the threshold for job creation in Spain. The recovery after the recession of end-1993 only materialised once GDP growth rates breached the 2% threshold, coupled with a context of credit expansion in Spain.

Spanish SME delinquencies reported by financial institutions to the Bank of Spain peaked at a record 12% in June 2014 (excluding real-estate exposure). Figure 10 shows the steep increase in delinquencies triggered by the recessionary period that started in

1Q09. Figure 10 also shows that the trend has not flattened yet. However, a sharp correction like the one at end-1993 is possible, as the Spanish economy is slowly recovering. The Bank of Spain expects 1.6% GDP growth for end-2014 and 2.0% for 2015.[7]

Figure 10 Spanish SME delinquencies[8] excluding real estate and construction



Source: Bank of Spain, statistical bulletin

In its long-term view, Scope remains cautious about the performance of Spanish SMEs beyond 2015. The longer term outlook depends more on other fundamentals, such as the ability to create added value and to compete on the market. In particular, in-depth labour market reform and an improvement in internal demand remain necessary to drive the economic recovery in Spain beyond 2015.

SME's improving access to credit

Banks are slowly modifying the tight underwriting standards implemented to protect their capital throughout the recession. A number of European banks have completed their balance sheet restructuring. The restructuring included deleveraging and recapitalisation, as well as provisioning for bad assets. Spanish banks, for instance, are now better capitalised and a race to increase market share in SME lending has begun.

In addition, initiatives by the ECB or supra-national bodies such as the EIF to promote SME lending at a pan-European level will support an improvement in funding conditions for SMEs in peripheral countries. This will bolster the performance of SME securitisations because the general availability of credit for SMEs (or its lack) very much determines the performance of this asset class.

[7] IMF figures predict 1.3% Spanish GDP growth for end-2014 and 1.7% for 2015. Scope relies on the Bank of Spain figures, which are independent as well and more recent.

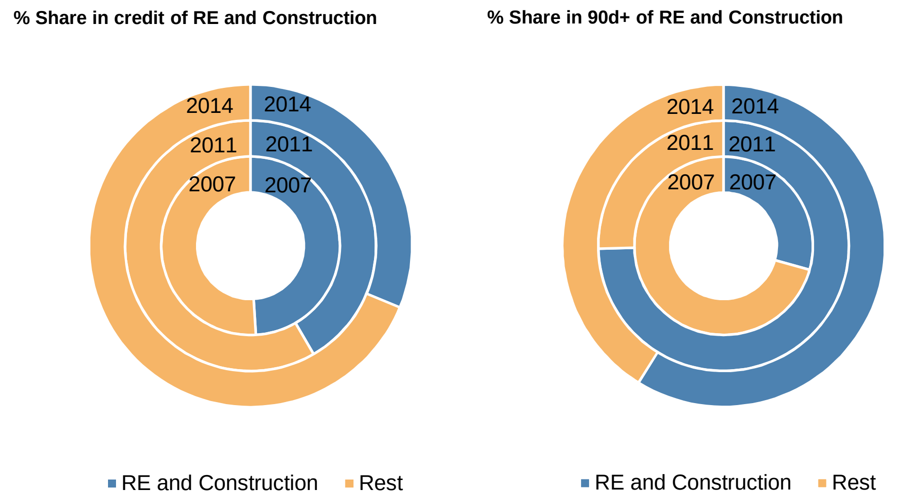
[8] Doubtful credit to other productive resident sectors, as defined by the Bank of Spain, used as a proxy for SME delinquencies.

Real estate and construction

Scope expects that the performance of new Spanish SME CLO securitisations will not be determined by the performance of real estate and construction. New lending to these sectors will be scarce, and underwriting scrutiny will be very strong. Real estate and construction still drive the gross delinquency levels in Spanish banks' balance sheets. However, the share of these sectors in total credit to productive sectors decreased to 31% in June 2014 from 50% in June 2007. And the weight in total delinquencies was 59% in June 2014 down from a peak value of 75% in June 2011 (see Figure 11).

Credit risk in the Spanish real estate and construction sectors triggered the Spanish recession as severe corrections were necessary to bring the weight of these sectors back to sustainable levels. The relative weight of real estate and construction in total delinquencies has declined. This reduction is explained by write-offs of bad credits to these sectors, and an increase in the delinquency levels of all other sectors (contagion effect).

Figure 11 Evolution of the weight of Spanish real estate and construction in total credit and total delinquencies of the Spanish financial system



Source: Bank of Spain. Data as of June of each year.

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