Catalonian crisis unlikely to affect Spanish SME ABS performance

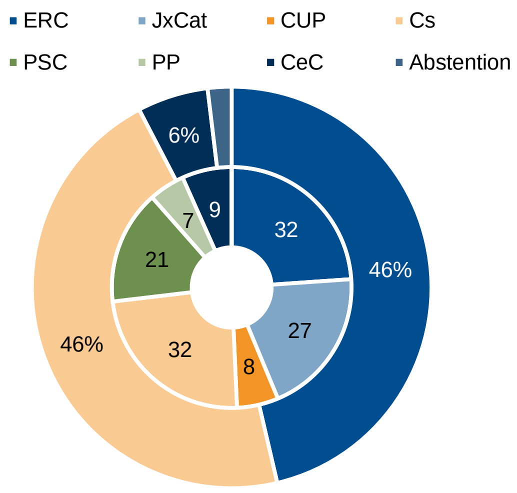
Irrespective of the outcome of the elections. Scope expects the performance of Spanish SME ABS portfolios to remain solid. Short-maturity Spanish SME ABS will not be materially affected by the Catalonian crisis, although an extension of the turmoil beyond 2018 could hurt longer-maturity mezzanine and junior tranches in portfolios exposed to the region and to large mortgage buckets.

Scope does not expect a material impact on the performance of Spanish SME ABS, despite the costs of the Catalonian crisis. Short-maturity senior tranches benefit from robust credit fundamentals and a strong economic recovery momentum. A prolongation of the political crisis beyond 2018 could have a negative credit impact on longer maturity mezzanine and junior tranches with underlying SME portfolios exposed to Catalonia and real estate collateral. For new issues in 2018, we expect to see transactions with lower levels of credit enhancement and excess spread, driven by the solid credit fundamentals of Spanish SME obligors.

On 27 October, the Spanish government dissolved the Catalan parliament, setting new elections for 21 December, after secessionist parties had unilaterally declared the region's independence following an illegal referendum. The crisis exposes Spanish SMEs to the economic costs of increased uncertainty and political instability. Notwithstanding, Scope considers a secession scenario to be highly remote, given Catalonia´s high dependence on State financing, plus institutional safeguards and political imperatives (see Scope's research 'Catalan election will not lead to the region's independence – regardless of the result', December 2017).

Regardless of the winner of today's elections, the Catalan parliament is likely to remain highly fragmented and the society deeply divided between supporters of pro-independence parties (ERC, JuntsXCat and CUP[1]) and those of unionist parties (Cs, PSC and PP[2]) (see Figure 1). Polls indicate that the remainder of the voters will either abstain or support CeC[3], a left-wing party which opposed the unilateral declaration of independence, but which supports greater autonomy for the region.

Figure 1: Expected number of parliamentary seats and share of vote



Source: Scope, based on average of public surveys

[1] ERC = Republican Left of Catalonia, JuntsXCat = Junts per Catalunya, CUP = Popular Unity Candidacy
[2] Cs = Ciudadanos, PSC = Socialists' Party of Catalonia, PP = Partido Popular
[3] CeC = Catalunya en Comu-Podem

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Catalan crisis should trigger a reduction of Spanish GDP growth

In 2018, costs of political uncertainty will materialize both at the regional and national level, mainly driven by a postponement of investment and consumption decisions. The Catalan crisis should trigger a reduction of Spanish GDP growth, under a baseline scenario, of between 0.1% and 0.3%.[4] The economic slowdown attributable to the secession-related turmoil will be even more pronounced in Catalonia. Scope expects 2018 year-on-year GDP growth of 2.5% and 2.1% for Spain and the autonomous region, respectively.

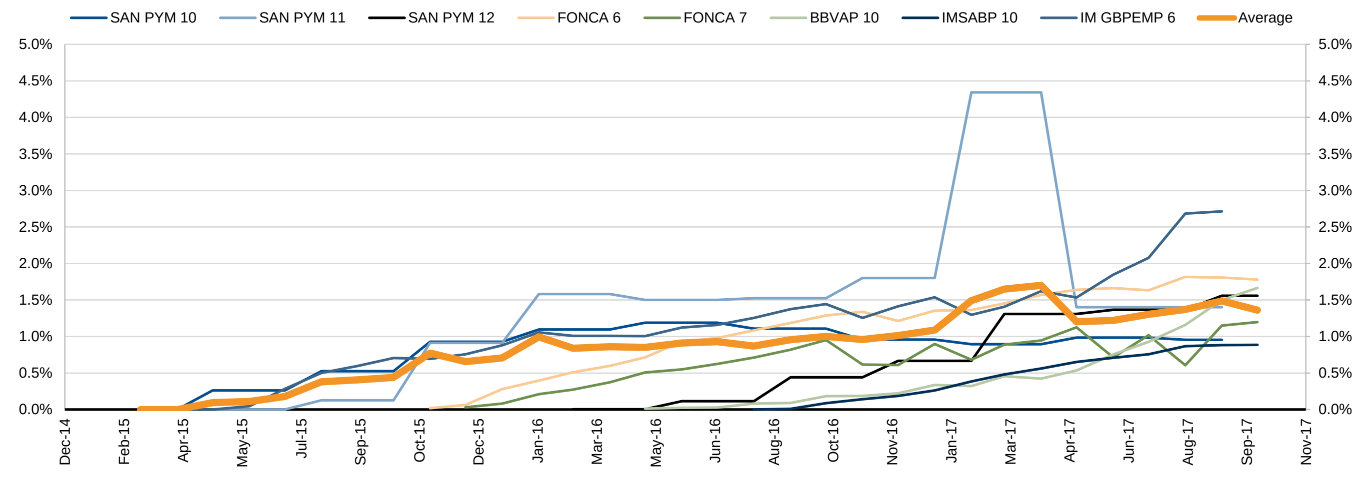
However, Scope is mindful that the evolving institutional and legal framework, particularly regarding the fiscal relations between the central government and the autonomous communities, may have a negative impact on long-term growth, if the institutional crisis continues to dominate the political agenda, delaying necessary reforms. Scope notes that, despite the positive recovery momentum, Spain remains highly indebted with nominal debt-to-GDP ratio expected to only gradually fall to around 95% by 2019. In addition, the high unemployment rate of 17.4% (2017F), the second highest in the euro area after Greece, points to the need to continue implementing structural reforms, also with a view to preparing the economy for the next cyclical downturn.

Outlook for Spanish SME ABS rated by Scope

Positive performance of outstanding SME ABS expected

Scope expects a positive performance from the five currently outstanding Spanish SME ABS that it rates, underpinned by recovery momentum, highlighted by above Eurozone average economic growth (3.1% in 2017), a significant drop in the unemployment rate from 19.6%, on average, during 2016 to 17.4% in 2017, the deleveraging of the private sector, and a gradual recovery of the real estate market. Solid credit fundamentals are reflected in the positive performance of the underlying collateral pools to date (see Figure 2). In 2018, we expect 90+ days-past-due delinquencies will remain below 2% on average.

Figure 2: Spanish SME CLO 90+ days past due delinquencies[5]



Source: Scope

In addition, the performance of Spanish SMEs is supported by extensive credit availability, which will continue, as the deleveraging process initiated with the financial crisis has been largely completed. Based on Bank of Spain data, we estimate that new credit availability to the SME sector increased year-on-year by approximately 8.5%, as of Q3 2017.

[4] Based on public sources (Bank of Spain and Ministry of Economy), leading Spanish banks research departments (BBVA, Santander), among others.
[5] Numbers refer to Spanish SME ABS rated by Scope between 2014 and 2016.

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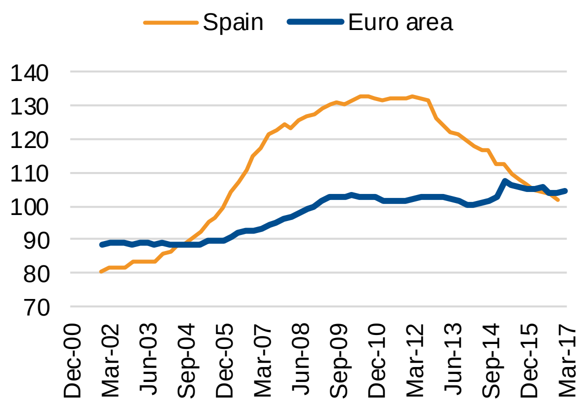
Spanish corporate sector has deleveraged by about 40%

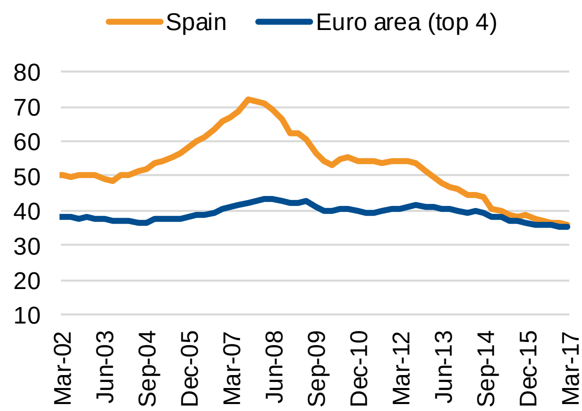
The Spanish corporate sector has deleveraged by about 40% relative to GDP since the financial crisis, falling below Eurozone average debt levels (see Figure 3). The increase in confidence, employment and economic stability helped make the reduction compatible with growth in turnover levels and investment (see Kingdom of Spain Rating Report, 30 June 2017). Besides deleveraging, ultra-low interest rates supported by ECB monetary stimulus have boosted credit service capacity: Corporate debt service ratios have fallen by over 50% since the financial crisis - from 72.2% to 35.3% (as of Q2 2017), converging with Eurozone average levels (see Figure 4).

Figure 3: Debt of non-financial corporates as % of GDP



Source: Bank for International Settlement

Figure 4: Corporate debt-service ratios



Source: Bank for International Settlement

Senior SME ABS tranches unaffected

Senior SME ABS tranches not to be affected

Spanish SME ABS senior tranches of existing transactions rated by Scope will not be impacted by the Catalan crisis, given the combination of i) the positive economic impetus, ii) the build-up of CE levels since closing to 34.2% from 28.0%, on average), iii) the tranches' short expected remaining lives, and iv) the moderate exposure of the SME underlying portfolios to Catalonia. Scope expects the economic impact of political uncertainly to be contained in the short-term, given the very positive recovery strength of the Spanish economy, supported by the tailwinds of the Eurozone recovery and ECB policy (see 2018 Structured Finance Outlook).

Turmoil beyond 2018 could hurt long-maturity instruments

Prolonged political crisis could adversely affect non-senior SME ABS tranches

A prolongation of the political crisis beyond 2018 could have a negative credit impact on current outstanding mezzanine and junior tranches, which have a longer remaining term to maturity and would be the first to absorb any add-on portfolio losses related to the Catalan situation. The average exposure to Catalonia in the underlying SME portfolios is about 20.8%[6], equivalent to more than 90% of the collateral value of the mezzanine and junior tranches. Especially, SME portfolios with long term mortgages may expose these tranches to potential mid-to-long-term adverse economic impacts.

New issues in 2018

New issues expected with lower credit enhancement and excess spread

For new issues in 2018, we expect to see transactions with lower levels of credit enhancement and excess spread, driven by the solid credit fundamentals of Spanish SME obligors and the tightening of loan margins observed between 2014 and 2016.

[6] Spanish SME ABS have a significant share of their portfolio in the Catalunya region resulting from the regional mix in Spanish banks SME lending strategy, which generally aligns with the current contribution of the regions to the economic output of Spain.

Arrangers will likely optimise the transactions, considering i) the European Central Bank's collateral haircuts[7], and ii) the good expected collateral performance, but also iii) the uncertainty spurred by the evolutions in Catalonia.

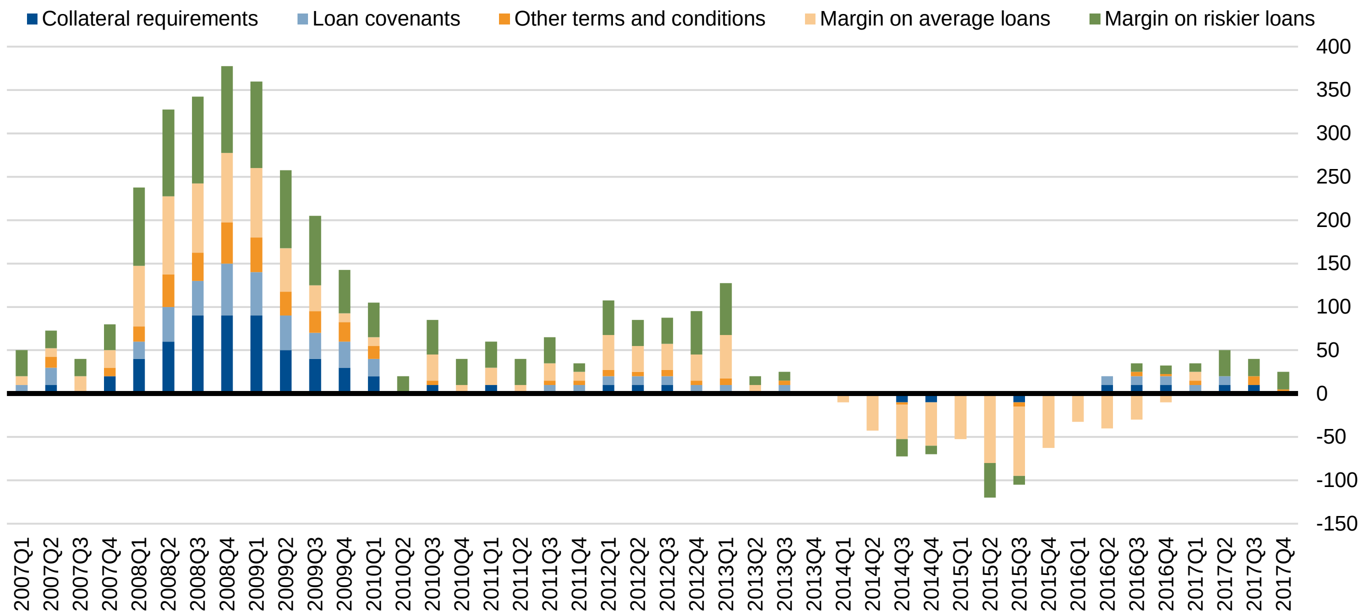
Securitised portfolios might enjoy the positive effects from well-seasoned recycled exposures combined with the potentially good credit profile of new origination: In 2018, a significant amount of collateral from called transactions will be available to re-issue SME securitisation. These assets will be mainly SME mortgages, stemming from transactions issued after 2014 and called after the redemption of the most senior tranche[8].

Robust credit quality of new originated collateral

Availability of credit does not constrain SME performance in 2018

We expect the lending environment to evolve within reasonable limits. Declining loan margins have contributed to a net easing of lending conditions since 2014, but only following a strong tightening of underwriting standards experienced after the financial crisis. However, since 2016 Q2, banks have reported a decrease in risk tolerance[9] reflected in margin increases on riskier loans (see Figure 5), despite a backdrop of increased competition.

Figure 5: Development of credit terms and conditions



7 Most new transactions will still focus on ECB eligibility as the refinancing at 0% is uncontested in the current markets for SME ABS securities.
8 The purpose of these retained transactions is to provide ECB collateral, which will mostly not be achievable, as soon as the senior tranches are paid off. Even if the remaining mezzanine and junior tranches would achieve the ECB collateral qualification (considered rather unlikely), we expect that the maintenance costs of the transactions will probably be higher than the liquidity benefit provided by these tranches.
9 Bank of Spain lending survey

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