

SME CLOs
Europe
Performance ReportEuropean SME CLO Performance
Tracker - June 2011

SME CLO Performance Stabilising

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Related Research

- *Rating Criteria for European Granular Corporate Balance-Sheet Securitisations (SME CLOs) (June 2011)*
- *Global Structured Finance Rating Criteria (August 2010)*
- *Criteria for European Structured Credit Issuer Report Grades (February 2010)*
- *Criteria for Structured Finance Loss Severity Ratings (February 2009)*

Performance Highlights**Spanish Transactions - Stabilising**

- Default rates and 90+ day average delinquency rates have now stabilised. This follows the rising trend in impairments observed over the last two years, which can mainly be attributed to a struggling real estate sector. However, in light of continued macroeconomic uncertainty in Spain and in the absence of structural reforms, Fitch Ratings believes SME borrowers will continue to operate in a stressed environment. As a result, Fitch expects delinquencies to remain at relatively higher levels.
- Fitch has observed an increase in realised recovery rates. However, due to the large over-hang of residential real estate that needs to be sold, Fitch expects a challenging foreclosure management process for Spanish transactions; this may imply a drop in collateral values as well as an increase in recovery lags.
- The sharp rise in the prepayment index which started two years ago has now abated. Fitch believes this drop in prepayment rates may be linked to a reduction in the number of restructured loans provided to distressed borrowers.

German Transactions - Performance Improves

- Fitch believes that on average, German SME delinquencies will fall next year.
- The performance of German balance sheet transactions has been relatively stable through the recent stressed macroeconomic period, with moderate default rates.
- Since the last SME CLO Tracker was published in October 2010, performance across Fitch-rated German balance sheet transactions has improved, in terms of default rates expressed as a percentage of the initial pool balance.
- Schuldschein (certificates of indebtedness) transactions are underperforming the balance sheet segment. However, for two of the Fitch-rated Schuldschein transactions, the principal deficiency ledger (PDL) balances in absolute terms have remained almost unchanged since the last Tracker, due to the benefit of excess spread.

Updated European SME CLO Criteria

Fitch published an update to the “*Criteria for Rating European Granular Corporate Balance-Sheet Securitisations (SME CLOs)*” on 6 June 2011.

The most significant change is the lowering of SME base case delinquency assumptions over the medium and long term and increased correlation levels to maintain ‘AAA’ default rate assumptions.

Other key changes include: treatment of obligor concentration risk; adjustments to default probabilities (PDs) for delinquent loans; adjustments to the tiering of cure rates; and the inclusion of market value declines (MVDs) for collateral other than residential and commercial mortgages.

European SME CLO Criteria - Key Changes

Fitch has lowered its SME base case delinquency rate over the medium and long term, as the agency believes the macroeconomic environment has improved for SME borrowers since the last criteria was published in 2009. Despite the improved economic outlook, the strength and pace of further macroeconomic improvements is uncertain. In light of this uncertainty, Fitch’s base case delinquency assumptions are still above the long-term historical averages for SMEs. Fitch has also increased the correlation assumptions within the criteria to ensure ‘AAAsf’ rating default levels remain consistent with existing levels.

Figure 1

Expected Average Default Rate

ISO CODES	DE	NL	ES	IT	GB	PT	FR
Annual average default rate 2011 to 2016 (%)	2.5	2.5	3.75 ^a	3.5	3.0	4.5	3.0
Average five-year cumulative default rate (%) ^b	11.9	11.9	17.4	16.3	14.1	20.5	14.1
Default definition	Basel II	Basel II	Basel II	180dpd	Basel II	Basel II	Basel II

The benchmark rates are updated at least annually, or more frequently if new information is provided to Fitch. For example, the Fitch structured finance group holds regular macro meetings – including participants from its sovereign group – to discuss the performance outlook and assumptions for all sectors. The macro meetings may provide recommendations that would lead to an update of the expected average default rates

^a Excluding real estate and construction

^b The cumulative default rate is calculated based on survival rates as follows: $(1 - (1 - \text{Average Annual DR})^5)$

Source: Fitch

For Spain, the average annual default rate does not apply to the real estate and construction sector, for which Fitch expects a default rate of 14% for 2011. Including the real estate and construction sector – which represents approximately 45% of outstanding debt – the expected average annual default rate would be 6.25%.

Obligor Concentration Risk

For obligors which represent more than 50 basis points (bp) of the portfolio notional, Fitch will apply the following stresses:

- correlation uplift of 50%;
- recovery rate multiplier of 0.75;
- one year PD based on bank internal ratings, floored at 1.0%; and
- minimum PD of 25% if Fitch cannot assess the credit quality of large obligors.

Default Probabilities for Delinquent Loans

Fitch has increased the default probability assumptions for delinquent loans. The PD for a delinquent loan increases in line with its delinquency status. Once a loan has been delinquent for more than three months, it is assumed to have defaulted.

Tiering of Cure Rates

Fitch analyses the historical cure rates between default and foreclosure for the originating bank’s SME loan book to determine a base case expected cure rate over the life of the transaction. The base case assumption will be tiered for higher rating scenarios because Fitch believes the cure rate to be a function of economic stress; consequently, for more severe stress scenarios, the agency expects a lower cure rate.

Recovery Assumptions for Other Collateral

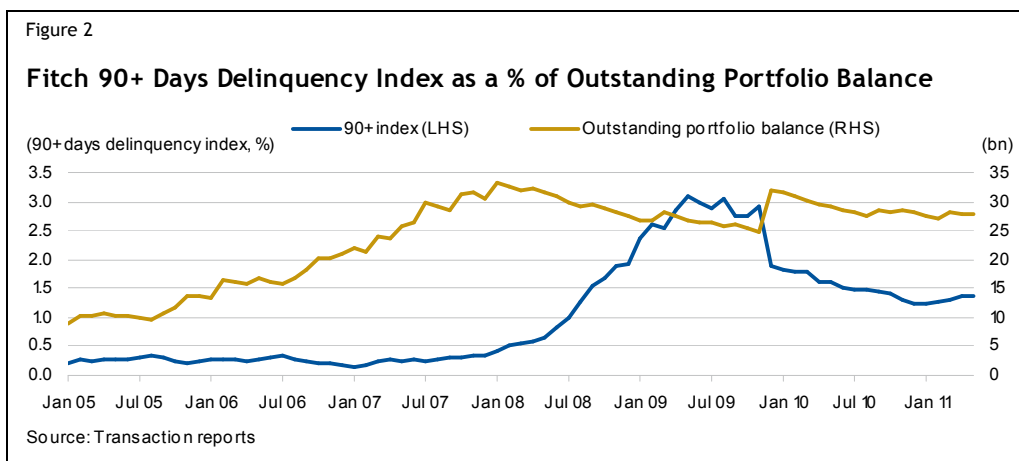
Fitch will give limited credit to collateral other than residential and commercial mortgages within the updated criteria. SME loans are often secured on other tangible and financial assets, such as inventory, receivables, stocks or various

pledges. Such collateral may be subject to significant price volatility and pledge agreements may not be as reliable as a mortgage right. Furthermore, it is not feasible to assign specific market value decline (MVD) assumptions to non-property collateral. Nevertheless, the existence of collateral improves recovery prospects.

Fitch Performance Indices

The graph below shows 90+ days delinquencies and the lowest rated bucket as a percentage of the aggregate outstanding transaction balance. All Fitch-rated transactions across jurisdictions are included in the respective indices, as long as the performance measure is reported. Users can customise indices with the latest version of Fitch’s SME CLO Compare.

90+ Days Delinquency Index Declines - Signs of Relief



The percentage of loans 90 days or more delinquent is showing signs of stabilising. This is partly due to newly issued transactions – which contain only performing loans – and is also a result of previously delinquent loans rolling into default.

German transactions are excluded from this measure as a delinquency by 90 days typically constitutes a default in these structures.

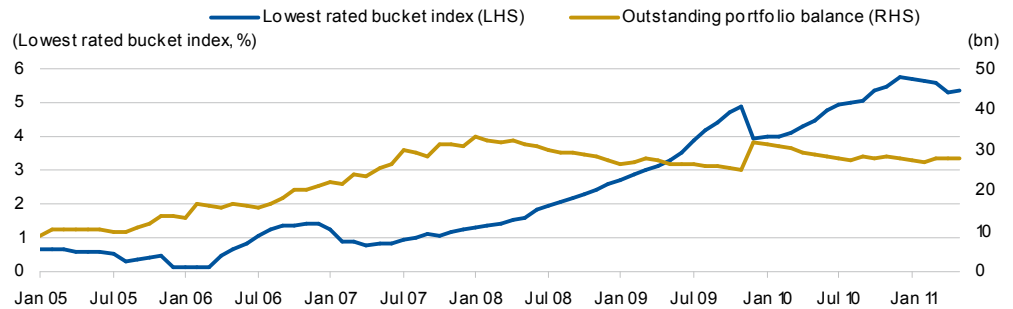
The 90+ Days Delinquency Index currently stands at 1.3%, significantly down from its peak of 2.3% in August 2009. More detailed analysis by region can be found on the following pages.

Lowest Rated Bucket Index Increases - Stabilisation Expected

The notional of assets in the lowest internal rating categories of the originating banks – associated by Fitch with ‘CCC’ or lower including defaults – has marginally increased in absolute terms over the past six months. Due to the decreasing pool notional of the amortising transactions, the relative amount of loans in originators’ lowest rated buckets has increased to 5.3%. Spanish transactions are excluded from this measure, as they do not report the originating bank’s internal rating scores.

Figure 3

Fitch Lowest Rated Bucket Index as a % of Outstanding Portfolio Balance



Source: Transaction reports

Reserve Fund Development - Further Depletions

Eight transactions within Fitch’s SME CLO universe currently have reserve fund balances of zero, of which five are Spanish and three German. Fitch expects further depletions for a number of transactions. The rebuilding of these reserve funds will depend on the future realisation of recovery proceeds from defaulted assets and the amount of excess spread within the structure.

Spanish SME CLO Performance Trends

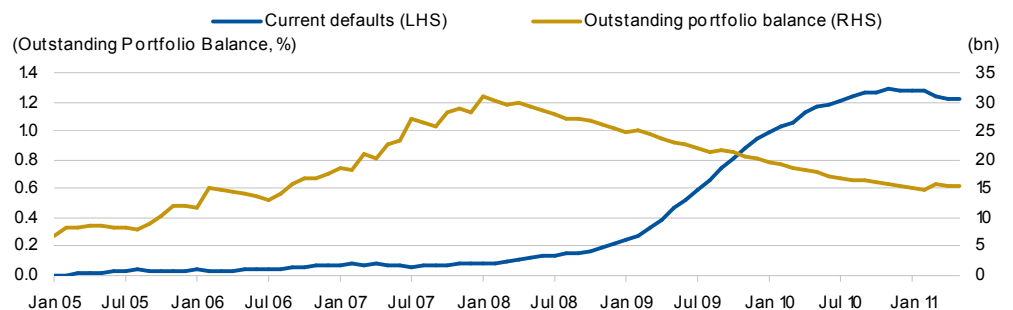
Cumulative Default Rates Plateau; Risk of Further Rises

Outstanding defaults as a percentage of the initial closing balances have now stabilised at 1.2%, following a sharp increase in loan impairments in the real estate (RE) and building and materials (B&M) sectors.

Fitch expects some further accumulation of non-worked out defaults in the near future. This is partly attributable to high default rates and partly because the recovery and foreclosure procedures in a stressed environment take longer than usual. The slower recovery process is especially important, given the large volume of real estate collateral Spanish banks are accumulating.

Figure 4

Spanish Current Defaults as a % of Outstanding Portfolio Balance

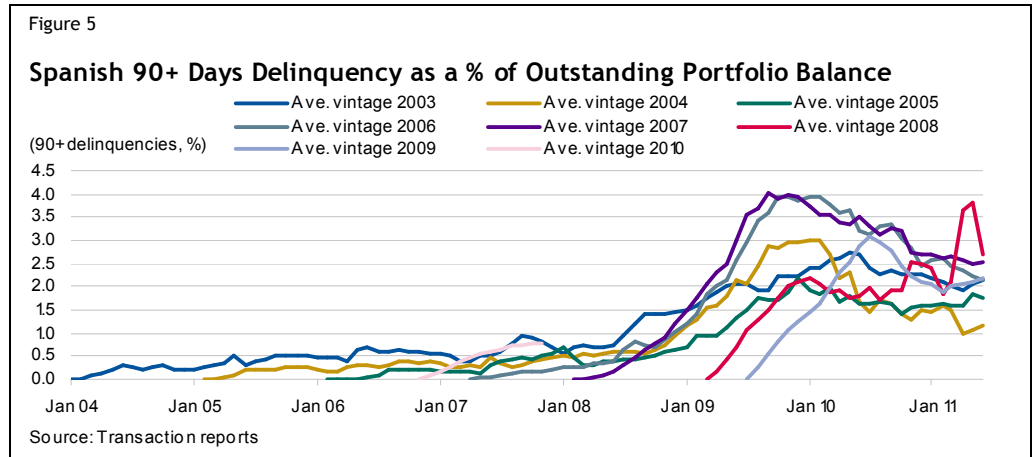


Source: Transaction reports

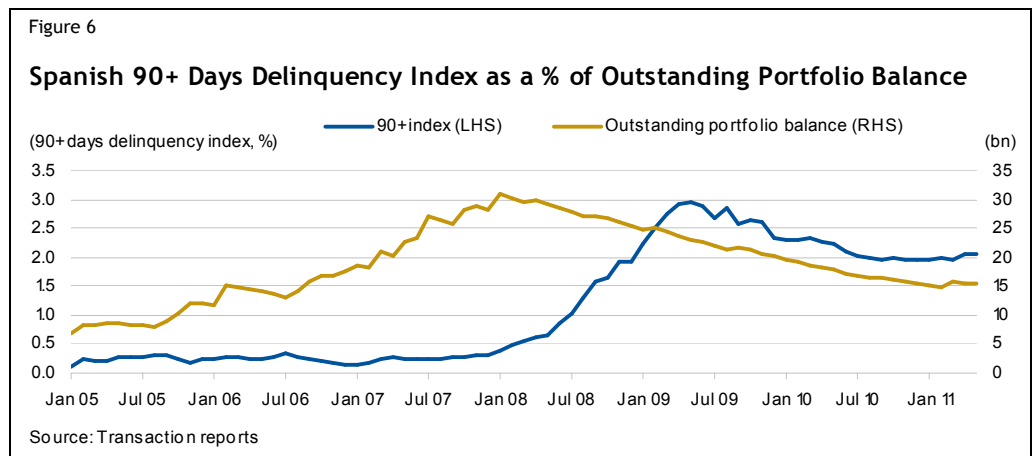
90+ Days Delinquency – Real Estate Delinquencies to Remain High

Delinquencies in Fitch’s universe of Spanish SME CLO transactions have fallen, some of which can be attributed to a drop in the delinquency rates in the RE and B&M sectors. This can be seen in the vintage performance graph below. The 2006 and 2007 vintage transactions typically have the highest exposure to real estate. Fitch maintains a negative outlook on those sectors and transactions with large remaining real estate exposure continue to be stressed in the agency’s rating analysis.

- Fitch expects an increasing number of reserve funds to fall below zero.
- 8 Transactions already have zero reserve funds.

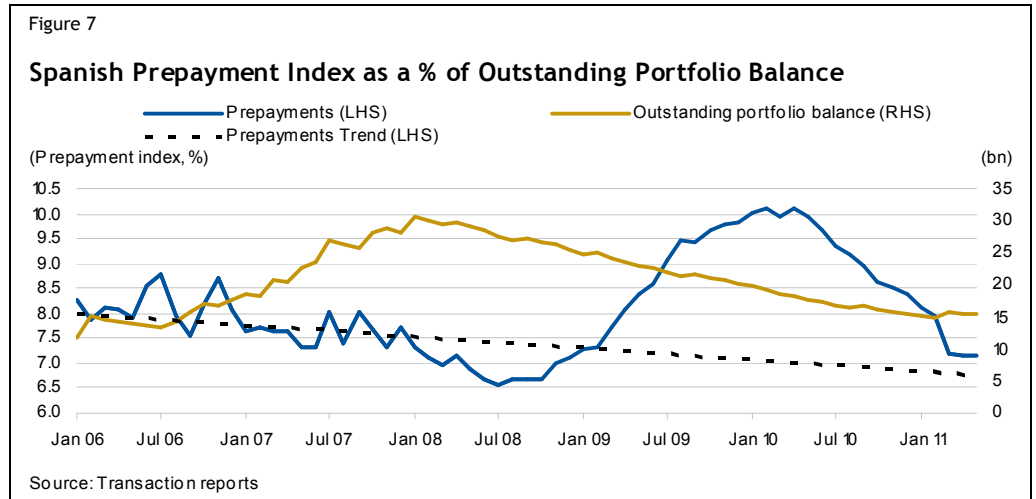


Fitch believes that Spanish SMEs will continue to be challenged by an uncertain macroeconomic environment. Limited credit availability and lack of profound labour market reform will keep delinquencies of more than ninety days at relatively high levels when compared with the low delinquency rates experienced during the boom years.



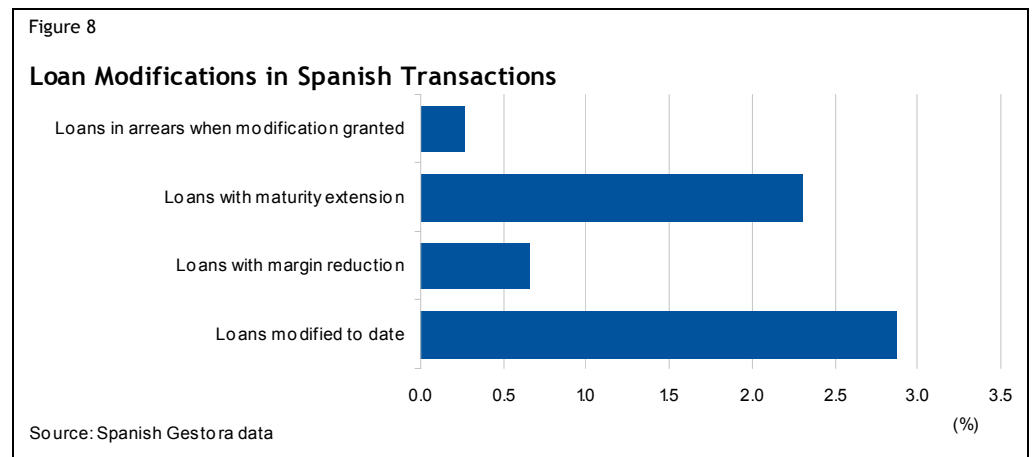
Prepayment Index Drops — Signs of Refinancing Squeeze

The Prepayment Index for Spanish SME CLO transactions has reverted to its downward trend after two years of uncharacteristically high prepayment rates. Fitch has previously commented that one explanation for the high prepayment rates may have been originators refinancing borrowers that may otherwise have encountered repayment problems. Now that these rates have dropped, the market may see a short-term reduction in restructured loans. Fitch does, however, continue to see originators support their transactions. Given that the initial support in 2007 and 2008 was frequently granted for two to three years, Fitch expects to see a new bout of support in the coming years. This support is not factored into Fitch’s analysis.

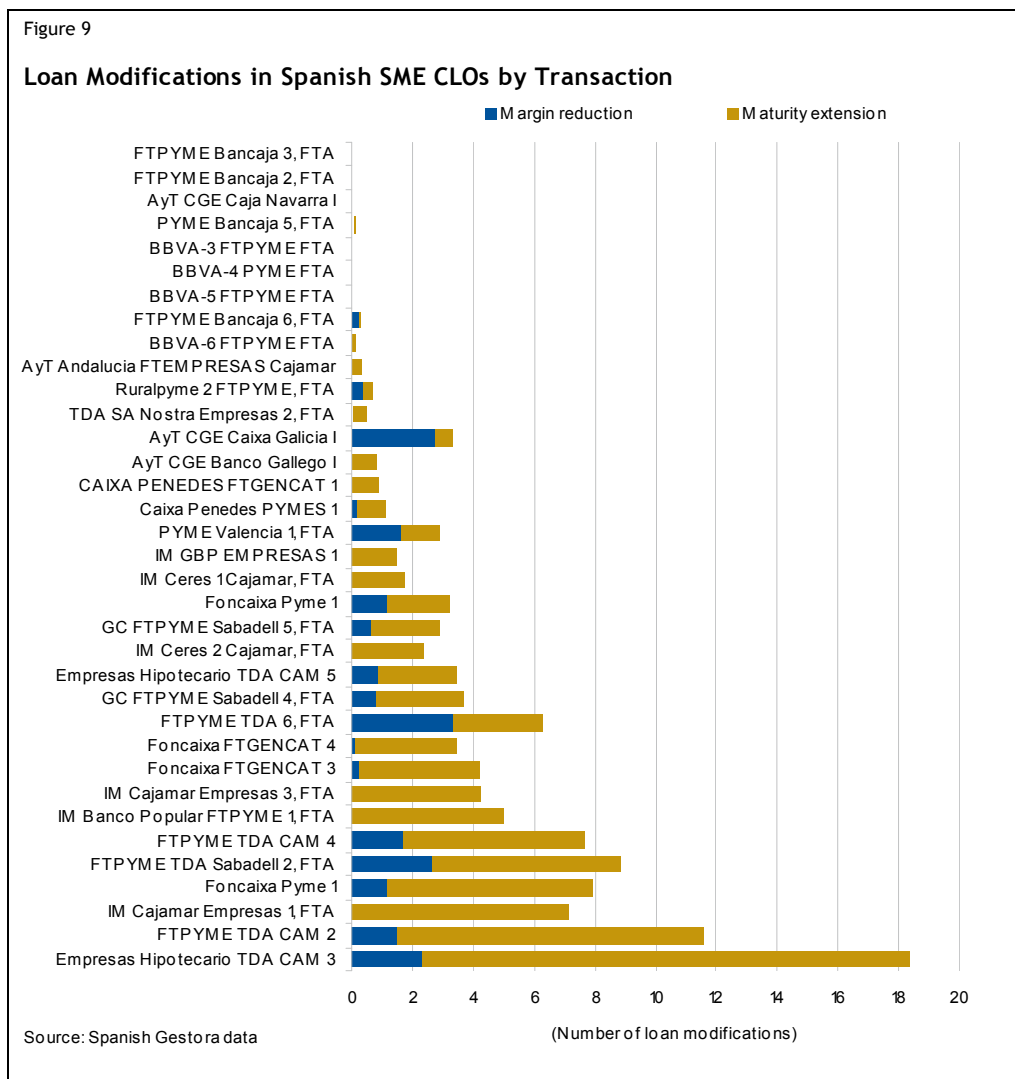


Loan Modifications

Fitch believes that major restructurings are reported as prepayments, as discussed above. This is because originators normally seek to increase the security level of the loans and this would require a new contract. However, originators continue to modify a small number of loans. On average, 2.9% of securitised loans within each transaction had been subject to some form of loan modification up to December 2010, with maturity extension (2.3%) and margin reduction (0.6%) being the most significant modifications. Such loan modifications comply with transaction covenants. Approximately 90% of loans modified by originators were performing at the time of the loan modification.



Fitch is monitoring those cases where the number of modifications is clearly above the sector average. The agency contacts originators in order to understand the servicing strategy that supports such actions.



German SME CLO Performance Trends

Fitch separates German SME CLO transactions within its rated portfolio into three segments: balance sheet securitisations; Geldilux transactions; and securitisations of Schuldschein loans (certificates of indebtedness). There are significant variations in characteristics and performance across the segments.

Balance Sheet Securitisations - Stabilisation Continues

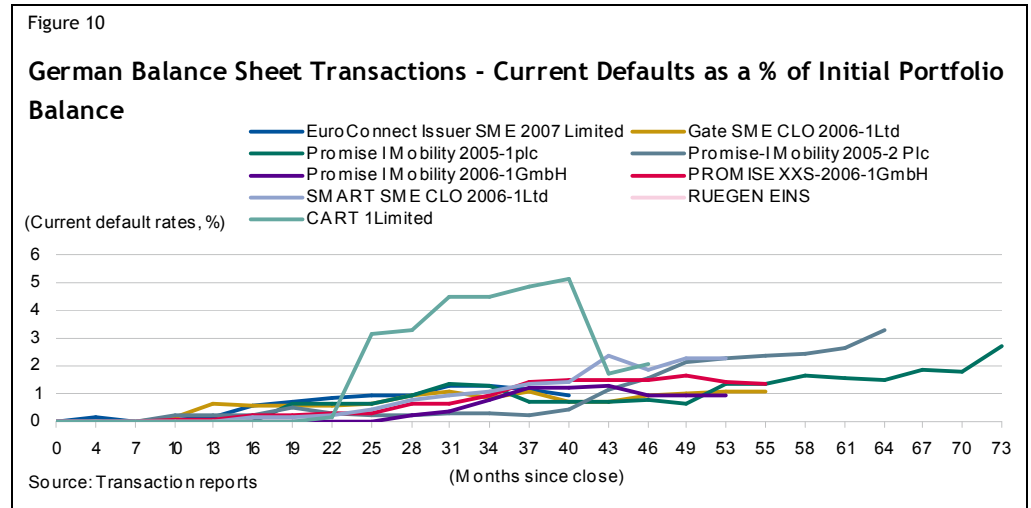
As a result of the improved macroeconomic environment in Germany, which has resulted in decreasing corporate insolvencies in recent months, Fitch believes that the performance of German balance sheet transactions will further stabilise.

Balance sheet transactions have experienced moderate default¹ rates since the last Tracker was published, with three Fitch-rated balance sheet transactions – EuroConnect Issuer SME 2007 Limited, PROMISE XXS-2006-1 GmbH, and CART 1 Limited – reporting a decrease in default levels as a percentage of the initial pool balance over the reported period.

The other Fitch-rated balance sheet transactions have shown a moderate increase in defaults, with Promise I Mobility 2005-1 plc and Promise-I Mobility 2005-2 Plc experiencing the highest current default rates (2.7% and 3.3% respectively of the

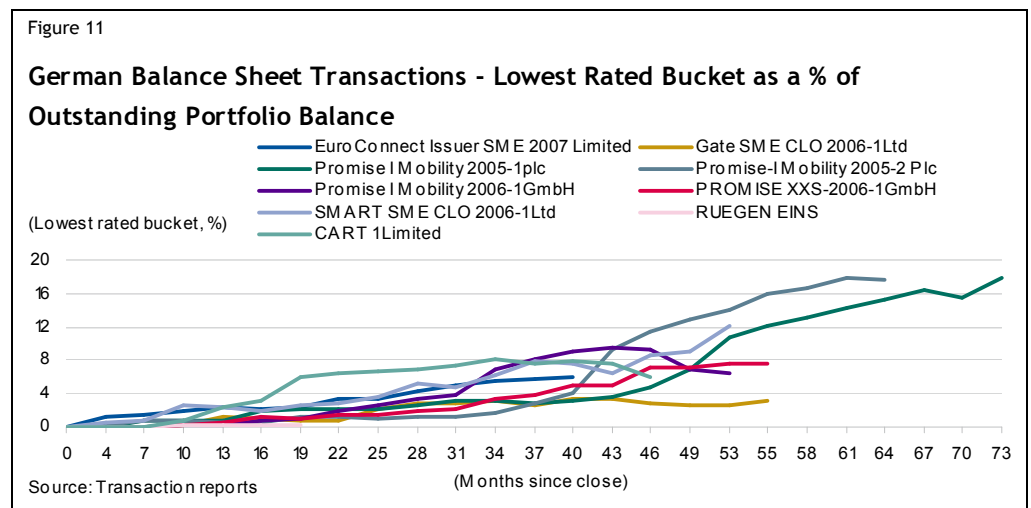
¹ A default or credit event is typically defined as: a delinquency of over 90 days; an insolvency; bankruptcy of the borrower; or a provisioning of such loan by the originating bank

initial portfolio balance). The weighted-average current default rate across all Fitch-rated balance sheet transactions fell to 1.2%, from 1.4% as of the last tracker.² RUEGENS EINS GmbH has not experienced any defaults to date.



Over the past eight months (since the Tracker in October 2010), the proportion of borrowers with very weak creditworthiness, including defaulted debtors (lowest-rated bucket) has decreased across half of all German balance sheet transactions, while the other half reported an increase. The highest increase, as a percentage of outstanding pool balance, was observed in SMART SME CLO 2006-1 Ltd (12.1% from 6.3% in October 2010), while the Promise I Mobility 2006-1 GmbH transaction reported the highest decrease (6.3% from 9.3%).

Figure 11 shows the “lowest-rated bucket” for German balance sheet transactions as a percentage of the outstanding pool balance.



Recoveries on worked-out assets in German balance sheet transactions currently range from 19% to 88%. This is expressed as a percentage of cumulative recoveries on total defaulted assets where the work-out process is finalised, translating into an average rate of 53% across all transactions. This broad recovery range is primarily attributable to varying degrees of collateralisation backing the loans.

² For the purpose of these calculations, Fitch did not consider the transaction S-Fix 1 GmbH which was assigned a Fitch rating as of 28 February 2011. S-Fix 1 GmbH has experienced a default rate of about 0.5% of the initial pool balance

Geldilux Transactions - Strong Performance but High Refinancing Risk

One outstanding Fitch-rated Geldilux transaction, Geldilux-TS-2007 S.A. – which securitises very short-term SME loans on a revolving basis – continues to show strong performance, with aggregate default rates very close to zero and no losses. Despite the stable performance, Fitch believes that the clustered maturities of the securitised loans lead to higher refinancing risk compared to maturities that are equally spread over the lifetime of a transaction. The magnitude of the refinancing risk depends on the ability of the originator (UniCredit Bank AG) to arrange refinancing if the underlying companies fail to do so. Therefore, in Fitch’s view, the transaction’s performance is likely to deteriorate if the originator’s creditworthiness deteriorates.

Schuldschein Transactions - Underperformance Continues

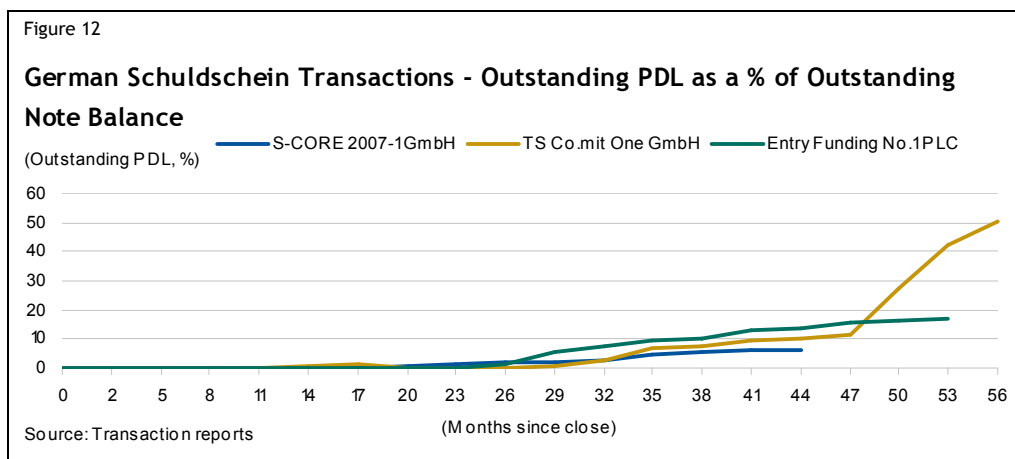
Fitch rates three transactions within this segment – TS Co.mit One GmbH, Entry Funding No.1 PLC, and S-CORE 2007-1 GmbH – which are essentially static pools of unsecured Schuldschein loans originated primarily to securitise. These portfolios tend to have high single obligor concentrations, ranging from 2% (S-CORE 2007-1 GmbH) to 10% (TS Co.mit One GmbH). The amortisation profiles differ significantly between the three transactions. While TS Co.mit One has deleveraged to 10%, Entry Funding No. 1 and S-CORE 2007-1 stand at 41% and 85% of their initial pool balances respectively.

The three transactions are clear underperformers, with default rates significantly higher as compared to balance sheet deals. There is a structural mechanism present in these transactions to provision recoveries and excess spread against defaults.

Since the last Tracker, the PDL balance has moderately increased for S-CORE 2007-1 (to EUR29.88m as of April 2011 from EUR21.15m in July 2010). For TS Co.mit One and Entry Funding No. 1, the PDL balances have remained almost unchanged for the same period, with current amounts of EUR15.29m and EUR33.9m respectively. The total outstanding PDL balances have increased relative to the outstanding notes in all three Schuldschein transactions.

The assets securitised in Schuldschein programmes are unsecured; therefore, Fitch expects the average final recovery rate to be around 20%.

The following chart shows the outstanding PDL balance relative to the total outstanding notes.



As a result of the relatively weak performance and the low recovery prospects, Fitch believes that the PDL balances are unlikely to be cleared, resulting in principal losses on the junior notes.

SME CLO Rating Migration

Figure 13

SME CLO Tranche Migration Since Transaction Closing (Number)

Number of tranches	Current ratings												Total no.
	PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf	Dsf	WD	
Initial ratings													
AAAsf	38	61	19	24	8	3	1	1	-	-	-	-	155
AAsf	5	3	14	5	9	2	6	2	1	-	-	-	47
Asf	-	-	-	29	7	9	3	6	1	-	-	-	55
BBBsf	1	-	-	1	16	20	8	18	8	-	-	-	72
BBsf	-	-	-	-	-	9	8	9	4	3	-	-	33
Bsf	-	-	-	-	-	-	8	-	-	2	-	-	10
CCCsf	-	-	-	-	-	-	-	-	3	6	-	-	9
CCsf	-	-	-	-	-	-	-	-	2	4	-	-	6
Csf	-	-	-	-	-	-	-	-	-	2	-	-	2
Total no.	44	64	33	59	40	43	34	36	19	17	-	-	389

Source: Fitch

Figure 14

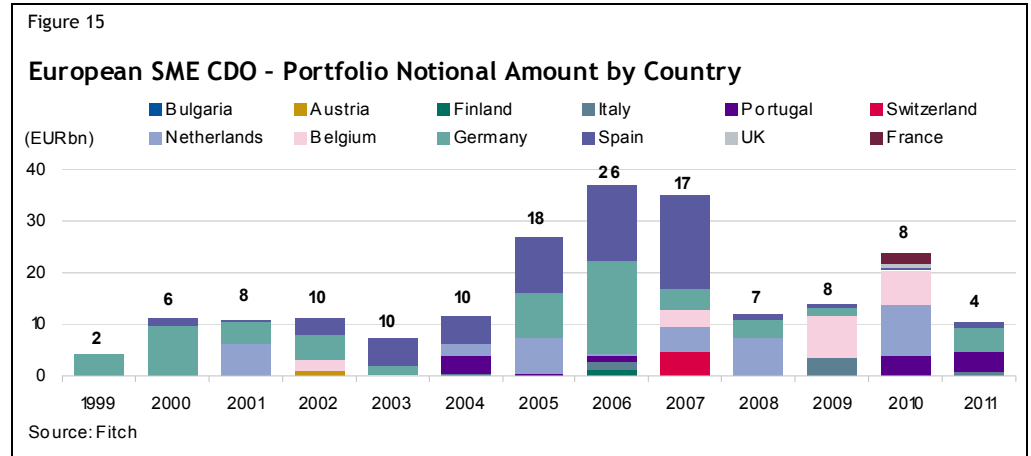
SME CLO Tranche Migration Since Transaction Closing (Percentage)

(% of tranches)	Current ratings (%)												WD
	PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf	Dsf	WD	
Initial ratings													
AAAsf	25	39	12	15	5	2	1	1	0	0	0	0	0
AAsf	11	6	30	11	19	4	13	4	2	0	0	0	0
Asf	0	0	0	53	13	16	5	11	2	0	0	0	0
BBBsf	1	0	0	1	22	28	11	25	11	0	0	0	0
BBsf	0	0	0	0	0	27	24	27	12	9	0	0	0
Bsf	0	0	0	0	0	0	80	0	0	20	0	0	0
CCCsf	0	0	0	0	0	0	0	0	33	67	0	0	0
CCsf	0	0	0	0	0	0	0	0	33	67	0	0	0
Csf	25	39	12	15	5	2	1	1	0	0	0	0	0

Source: Fitch

Appendix: Fitch-Rated SME CLO Issuance Volume

From 1999 to Q211, Fitch rated 134 SME transactions across Europe. The majority of these were from Spain (69 transactions, EUR64bn in portfolio amount) and Germany (33 transactions, EUR65bn in portfolio amount).



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