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Transition Study:

Five Years On, The European Structured Finance Cumulative Default Rate Is Only 1.1%

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European economic output has stalled since the end of 2011, and the region looks increasingly likely to fall back into recession, in Standard & Poor's Ratings Services' opinion. Moreover, the European unemployment rate reached a 15-year high of 10.4% in June, according to Eurostat. This setting has negative implications for securitization collateral performance. (Watch the related CreditMatters TV segment titled "Five Years On, Europe's Structured Finance Default Rate Remains Low," dated Aug. 30, 2012.)

However, despite these negative macroeconomic developments, only 1.11% of European structured finance notes outstanding in mid-2007 (by original issuance volume) had defaulted by mid-2012, with the 12-month-rolling default rate edging only slightly higher to 0.50%. Even amid the deteriorating European economy, worsening collateral performance, and the application of some updates to our ratings criteria, the rise in the 12-month-rolling downgrade rate slowed to only 30.8%. By contrast, we estimate that more than 58% of notes outstanding in mid-2007 have fully redeemed.

The bad economic news could have a more pronounced effect on our ratings in future, however, as an increasingly likely double-dip recession could further weaken collateral and ultimately transaction performance.

Overview

- Only 1.11% (by original issuance volume) of European structured finance notes outstanding in mid-2007 have defaulted.
- The 12-month rolling downgrade rate rose to 30.8% amid the deteriorating European economy, worsening collateral performance, and the application of some updates to our ratings criteria.
- Consumer-related securitizations have outperformed those backed by corporate loans, with cumulative default rates since mid-2007 of 0.03% and 3.59%, respectively.
- Senior notes outperformed those ranked more junior in the capital structure, with only 0.82% of ratings on 'AAA' issuance defaulting since mid-2007.
- On aggregate, 58.1% of notes that were outstanding five years ago have since seen rating withdrawals—usually due to full redemption.

This report is the latest update of our regular transition study, which we originally published on May 17, 2010 (see "European Structured Finance Cumulative Default Rate Since Mid-2007 Remains Below 0.5%"). As before, we quantify credit performance by analyzing notes' rating transitions and defaults—aggregating them by original issuance volume, rather than by the number of notes. This approach gives greater weight to larger notes, where the most investor funds are actually deployed—notably, those more senior in the capital structure and those in asset classes where transactions are typically larger.

In this study, we update our analysis to consider cumulative ratings transition and default rates from the beginning of the current financial downturn—which we assume to be in mid-2007—until mid-2012. We also analyze rating changes on a 12-month-rolling basis, to better highlight recent trends.

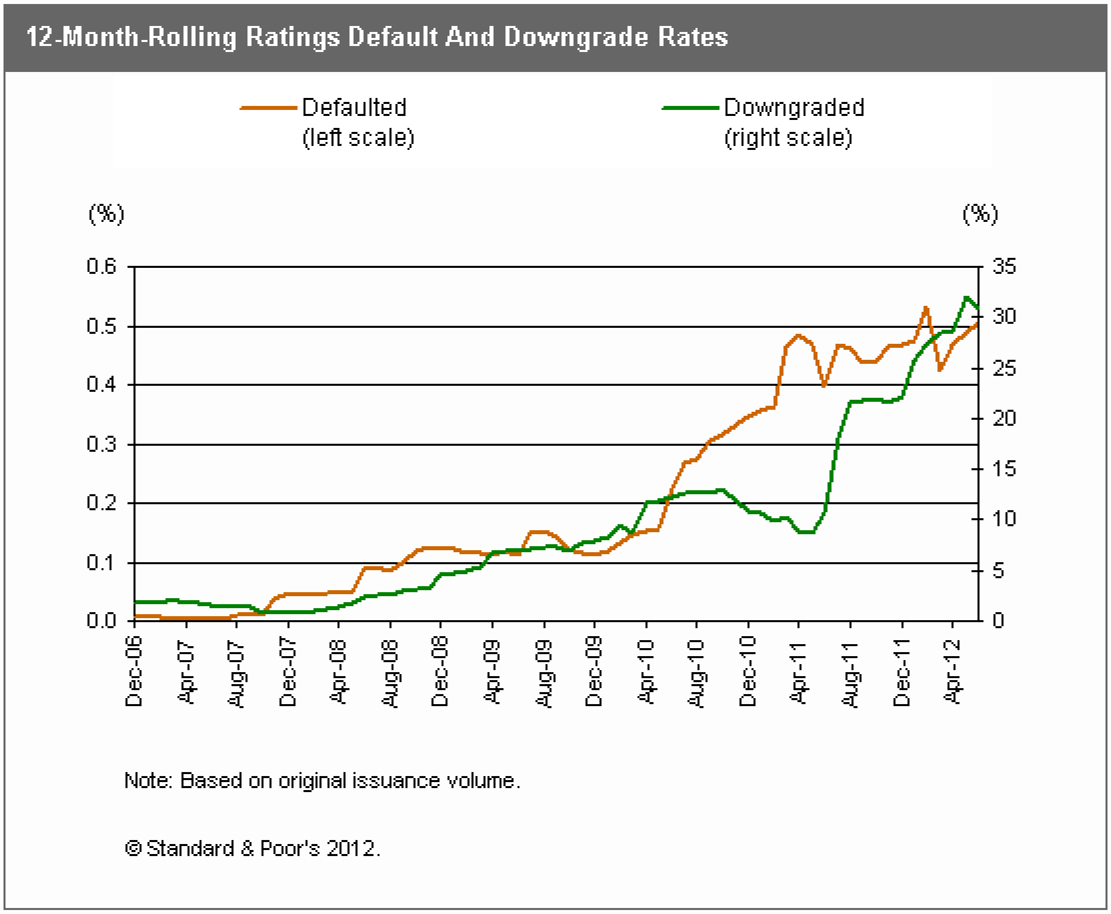
Application Of 2011 U.K. RMBS Criteria Stokes Downgrade Rate

Based on our calculations, only €30.7 billion of notes from an original issuance volume of €2,779.2 billion have defaulted since mid-2007—representing a 1.11% cumulative default rate. By definition, this cumulative measure of default can only increase over time, and rose slightly from 1.02% at end-Q1 2012. However, the European structured finance cumulative default rate remains low in absolute terms, for example, compared with the equivalent measure for U.S. structured finance, at 14.8% (see table 1).

Downgrade rates are always higher than default rates because deteriorating creditworthiness is more likely than actual failure to pay, in our view. The cumulative downgrade rate in the 20-quarter observation period between mid-2007 and mid-2012 was 32.8%. In other words, our ratings on 67.2% of European structured finance notes have either been stable or risen since mid-2007 (see tables 3 and 4 in the appendix for a full ratings transition matrix for European structured finance in that period).

The 12-month-rolling default rate rose to 0.50% by mid-2012 (see chart 1). The 12-month-rolling downgrade rate has also increased, reaching 30.8% by mid-2012. This increase was primarily due to the application of our U.K. RMBS criteria, updated in December 2011, which resolved our Q4 2011 criteria-related CreditWatch negative placements (see "U.K. RMBS Methodology And Assumptions," published on Dec. 9, 2011, and "Ratings On 764 Tranches In 119 U.K. RMBS Transactions Placed On CreditWatch Negative After U.K. RMBS Criteria Update," published on Dec. 12, 2011).

Chart 1



Consumer Transactions Remain More Resilient Than Their Corporate Counterparts

Many of the ratings transition and default trends vary substantially by asset class. We classify transactions into two broad categories:

- Consumer: residential mortgage-backed securities (RMBS), covered bonds, and consumer asset-backed securities (ABS); and
- Corporate: corporate securitizations, structured credit, commercial mortgage-backed securities (CMBS), and some other ABS.

When considering these classifications, consumer transactions have outperformed corporate transactions by a wide margin—with a cumulative downgrade rate of 26.5% and a cumulative default rate of only 0.03%, compared with 47.5% and 3.6%, respectively, for corporate transactions (see table 1 and chart 2).

Table 1

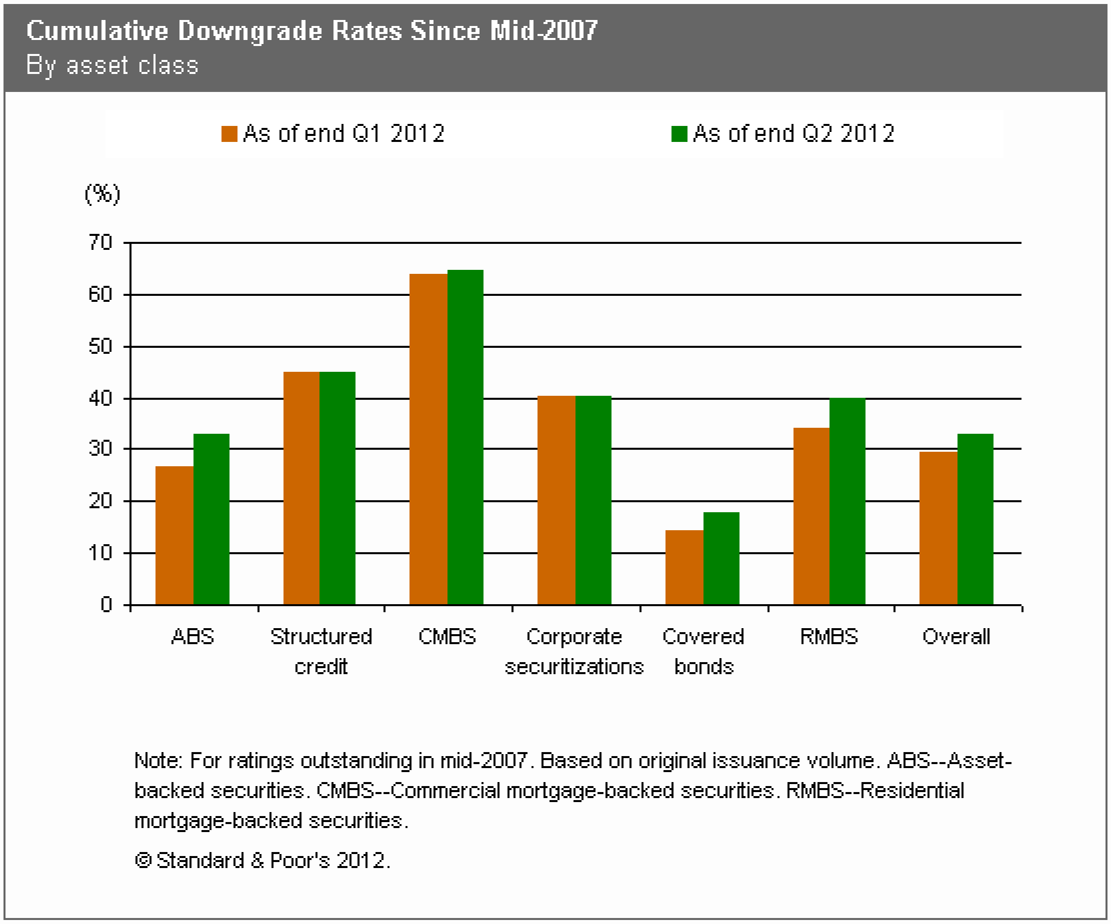
Summary Of Mid-2007 To Mid-2012 Ratings Transition, Default, And Withdrawal Rates

By asset class

		Ratings transition rate* (%)				
Asset class	**Total (bil. €)**	**Upgraded**	**Stable**	**Downgraded**	**Defaulted**	**Withdrawn**
ABS	275.2	3.4	63.5	33.0	0.16	64.5
Credit cards	33.2	0.0	97.0	3.0	0.00	91.8
Other consumer ABS	68.0	8.9	61.5	29.6	0.13	70.2
SMEs	103.0	0.6	58.2	41.2	0.23	56.7
Other ABS	71.0	3.9	57.6	38.5	0.16	57.5
Structured credit	432.8	2.7	52.4	44.8	5.10	69.1
Synthetic corporates	254.9	3.2	61.5	35.2	2.30	88.2
Leveraged loan CLOs	71.3	1.1	20.7	78.1	0.10	14.2
CDOs of ABS	28.9	0.4	14.5	85.0	39.44	20.2
Other CDOs	77.8	3.3	65.8	30.9	6.10	74.8
CMBS	163.2	1.3	34.0	64.7	4.55	29.6
Corporate securitizations	67.7	7.9	51.9	40.2	0.33	21.0
Covered bonds	1,084.5	0.1	82.3	17.6	0.00	62.4
RMBS	755.8	1.2	58.9	39.9	0.07	52.8
All consumer transactions	1,941.5	0.8	72.7	26.5	0.03	59.4
All corporate transactions	837.7	2.7	50.0	47.4	3.59	55.0
Overall	2,779.2	1.4	65.9	32.8	1.11	58.1
Overall U.S.	5,818.4	0.9	48.1	51.0	14.84	33.5

Note: For ratings outstanding in mid-2007. Based on original issuance volume. *We classify withdrawn ratings according to their levels immediately before withdrawal. ABS--Asset-backed securities. SME--Small and midsize enterprise. CLO--Collateralized loan obligation. CDO--Collateralized debt obligation. CMBS--Commercial mortgage-backed securities. RMBS--Residential mortgage-backed securities.

Chart 2



Cumulative downgrade rates have risen primarily in ABS and RMBS, and to a lesser extent in CMBS—due primarily to sovereign risk, the application of updated criteria, and poor collateral performance, respectively.

In ABS for example, we lowered our ratings on 41 ABS notes following our downgrade of Spain (see "Various Rating Actions Taken On 98 Tranches In 85 Spanish Securitizations Following Sovereign Downgrade," published on May 8, 2012, and "Ratings On Spain Lowered To 'BBB+/A-2' On Debt Concerns; Outlook Negative," published on April 26, 2012). The higher country risk associated with this downgrade means that, under our nonsovereign ratings criteria, we generally would not rate securities with Spanish underlying collateral higher than 'AA+' (see "Nonsovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions," published on June 14, 2011).

Additionally, negative rating actions on several Spanish banks subsequent to the sovereign downgrade, and the lack of remedial actions by affected transaction counterparties, combined with poor collateral performance, also triggered some downgrades (see "Negative Rating Actions On 16 Spanish Banks Following Sovereign Downgrade," published on April 30, 2012).

In RMBS, most of our negative rating actions were driven by the application of our 2011 U.K. RMBS criteria and, in some cases, deteriorating collateral performance.

In CMBS, downgrades resulted mainly from collateral–related issues, including sharp market value declines affecting recovery expectations and potential principal losses. Moreover, the low number of CMBS loans that fully repaid at maturity in Q2 2012 (nine out of 37), may not augur well for the repayment prospects of the 75 loans coming due in the second half of the year, and therefore our ratings (see "European CMBS Monthly Bulletin (July 2012): Downgrades Persist With Deteriorating Loan Performance," published on July 31, 2012).

In the past quarter, structured credit transactions' cumulative downgrade rate stabilized after a slight decline in Q1 2012 (see chart 3): The negative effect of the application of our CDO of ABS criteria, updated in February 2012, was offset by deleveraging and reduced time to maturity for a large number of transactions (see "Global CDOs Of Pooled Structured Finance Assets: Methodology And Assumptions," published on Feb. 21, 2012).

The 12-month-rolling ABS and RMBS default rates are still very low at 0.05% and 0.36%, respectively—a fraction of those for structured credit and CMBS at 2.88% and 1.94%, respectively (see chart 4).

Chart 3

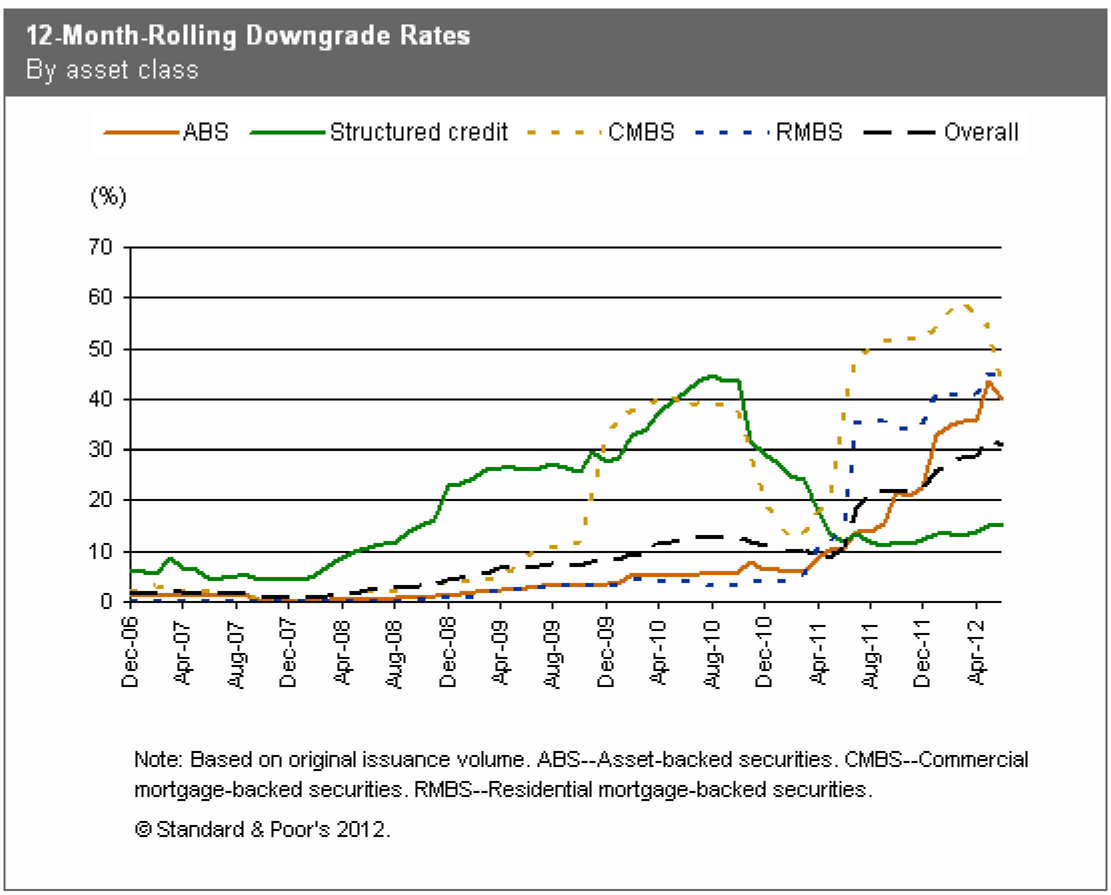
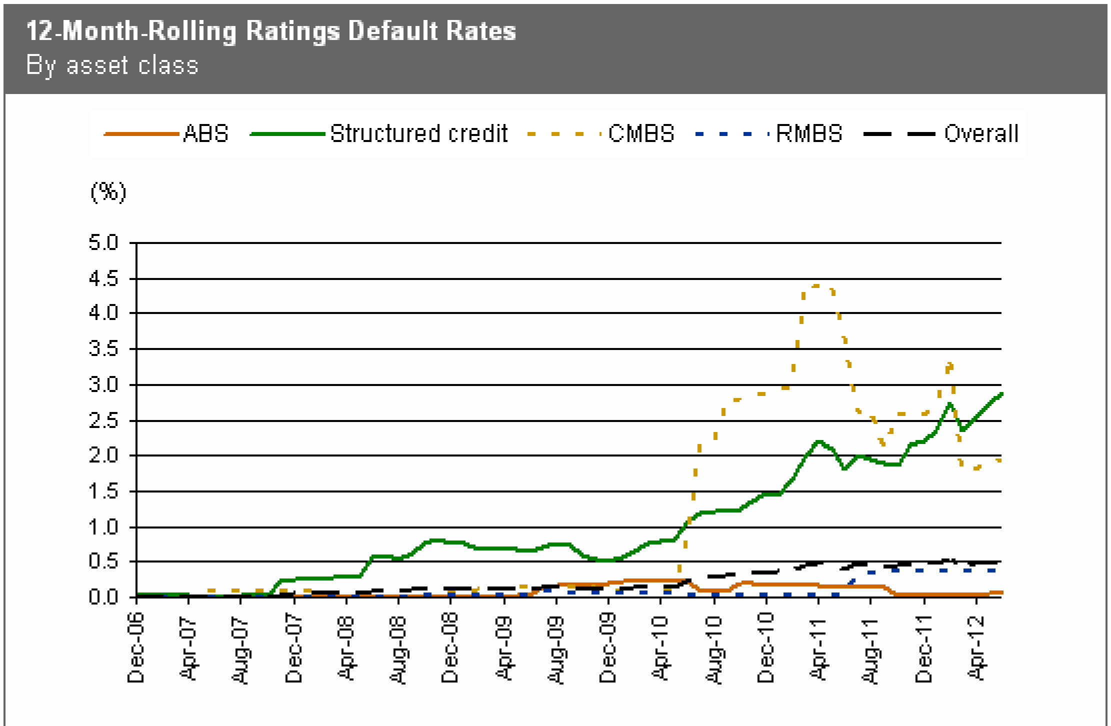


Chart 4



Note: Based on original issuance volume. ABS--Asset-backed securities. CMBS--Commercial mortgage-backed securities. RMBS--Residential mortgage-backed securities.

Only One-Third Of Investment–Grade Notes Downgraded Since Mid-2007

In our view, the position of notes in the capital structure affects their credit performance. In fact, the cumulative downgrade rate for speculative-grade notes between mid-2007 and mid-2012 was more than 50% higher than for investment-grade notes, with the former recording a cumulative downgrade rate of 54.9%, compared with 32.6% for the latter (see table 2 and chart 5). More significantly, the cumulative default rate for speculative-grade notes, at 9.43% in the same period, has been almost 10 times higher than that for investment-grade notes, at 1.06%.

This result is not surprising. The gap in both downgrade and default rates is consistent with our ratings framework: Default propensity and credit stability are key rating factors, and we therefore expect ratings on more senior notes generally to be more stable than those on junior notes experiencing similar stresses (see "Methodology: Credit Stability Criteria," published on May 3, 2010).

Table 2

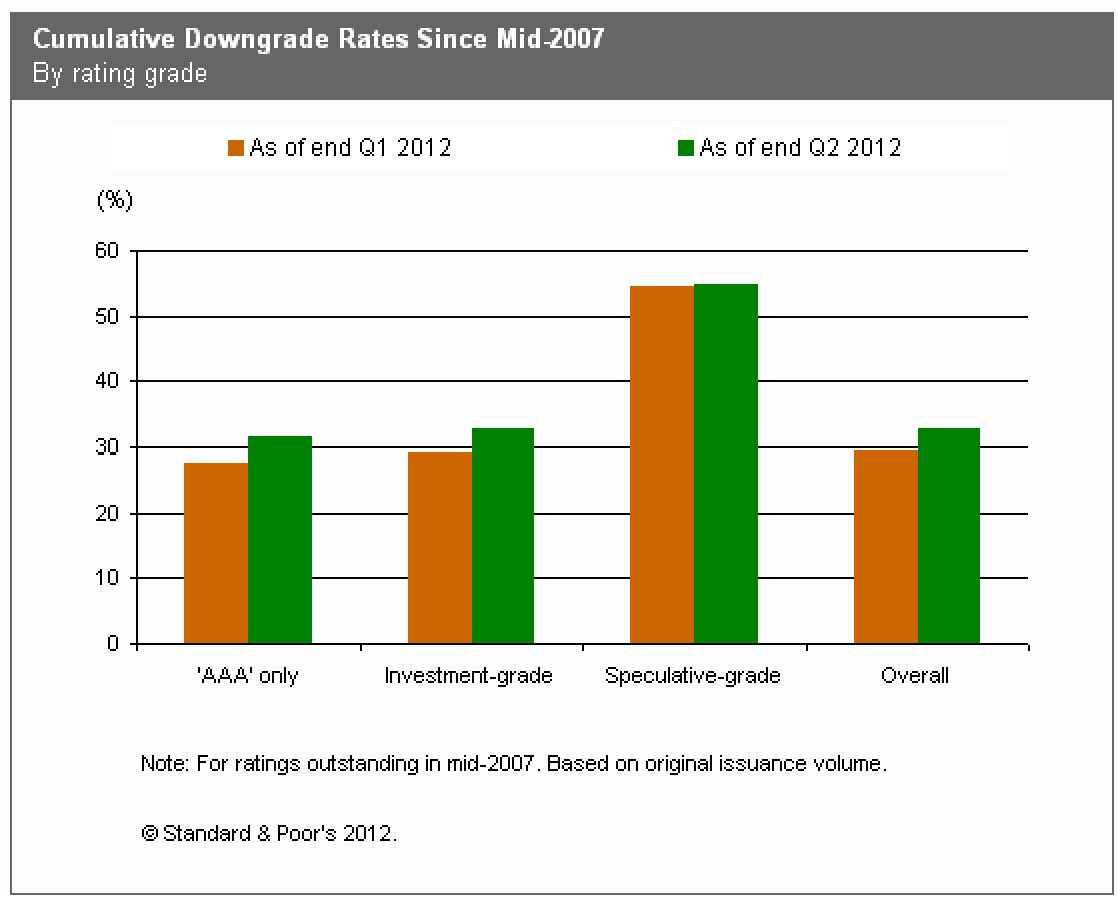
Summary Mid-2007 To Mid-2012 Ratings Transition, Default, And Withdrawal Rates

By rating grade

		Ratings transition rate* (%)				
	Total (bil. €)	**Upgraded**	**Stable**	**Downgraded**	**Defaulted**	**Withdrawn**
Investment-grade	2,763.1	1.3	66.0	32.6	1.06	58.2
'AAA' only	2,417.7	0.0	68.4	31.6	0.82	58.5
Speculative-grade	16.1	7.6	37.6	54.8	9.43	49.3
Overall	2,779.2	1.4	65.9	32.8	1.11	58.1

Note: For ratings outstanding in mid-2007. Based on original issuance volume. *We classify withdrawn ratings according to their levels immediately before withdrawal.

Chart 5



More Than Half Of Notes Have Redeemed Since Mid-2007

Regardless of whether note ratings have remained stable, moved up, or moved down, it is also important to consider that much of the principal outstanding in mid-2007 is by now no longer at risk—and has been returned to noteholders—due to amortization. In fact, many of these notes have now redeemed in full. We can obtain a proxy for the scale of full note redemptions by considering rating withdrawals, as these have most often occurred following full note redemption.

By mid-2012, we had withdrawn our ratings on 58.1% of notes that were outstanding in mid-2007 (see chart 6). This high number is all the more positive, in our view, given that European structured finance is currently experiencing a period of unusually low prepayment rates on many types of underlying collateral.

Withdrawal rates vary widely across different asset classes (see chart 7). Structured credit, ABS, and covered bonds report the highest cumulative withdrawal rates at 69.1%, 64.5%, and 62.4%, respectively. Withdrawals were broadly for different reasons in each asset class: Structured credit withdrawals followed terminations and defaults, while ABS and covered bonds respectively have collateral with traditionally short maturity dates and bullet maturity dates, which many of the notes outstanding in mid-2007 would now have reached. The CMBS cumulative withdrawal rate is comparatively low at 29.6% because many of the underlying loans' bullet maturity dates have been extended, making early repayment of the notes unlikely.

Chart 6

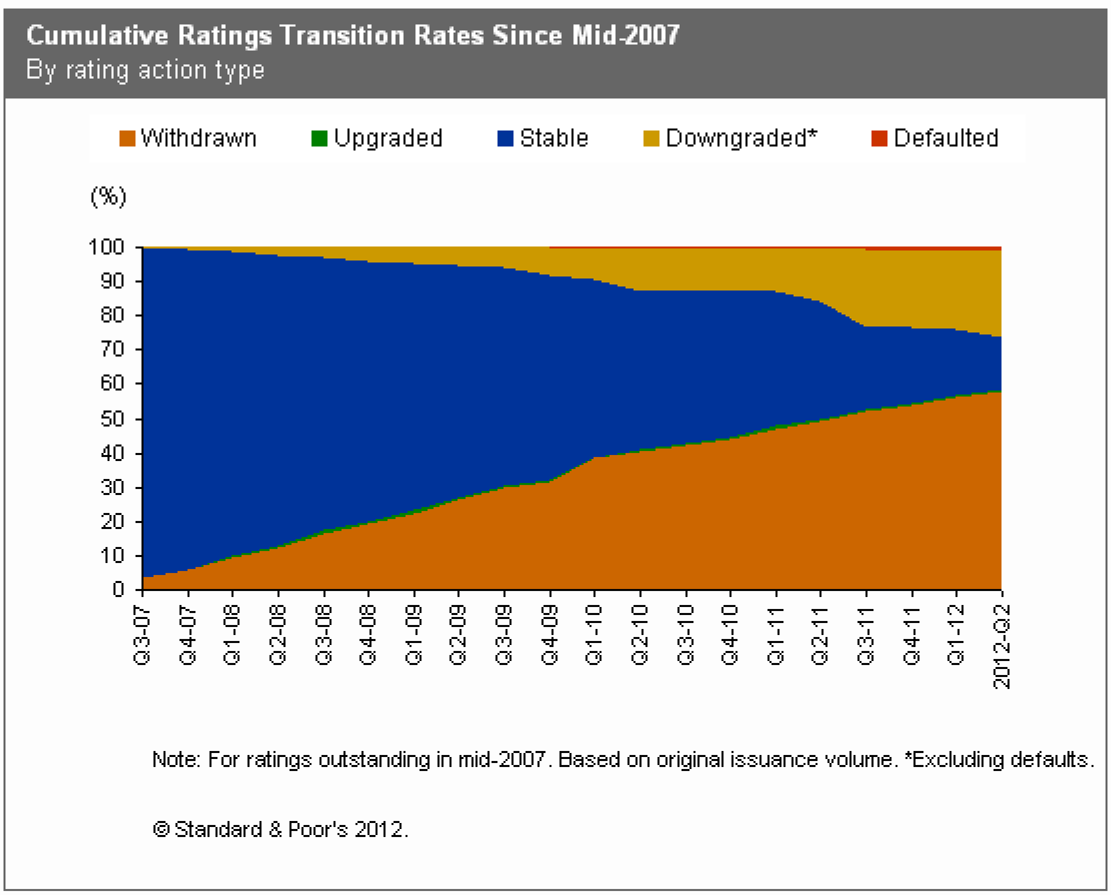
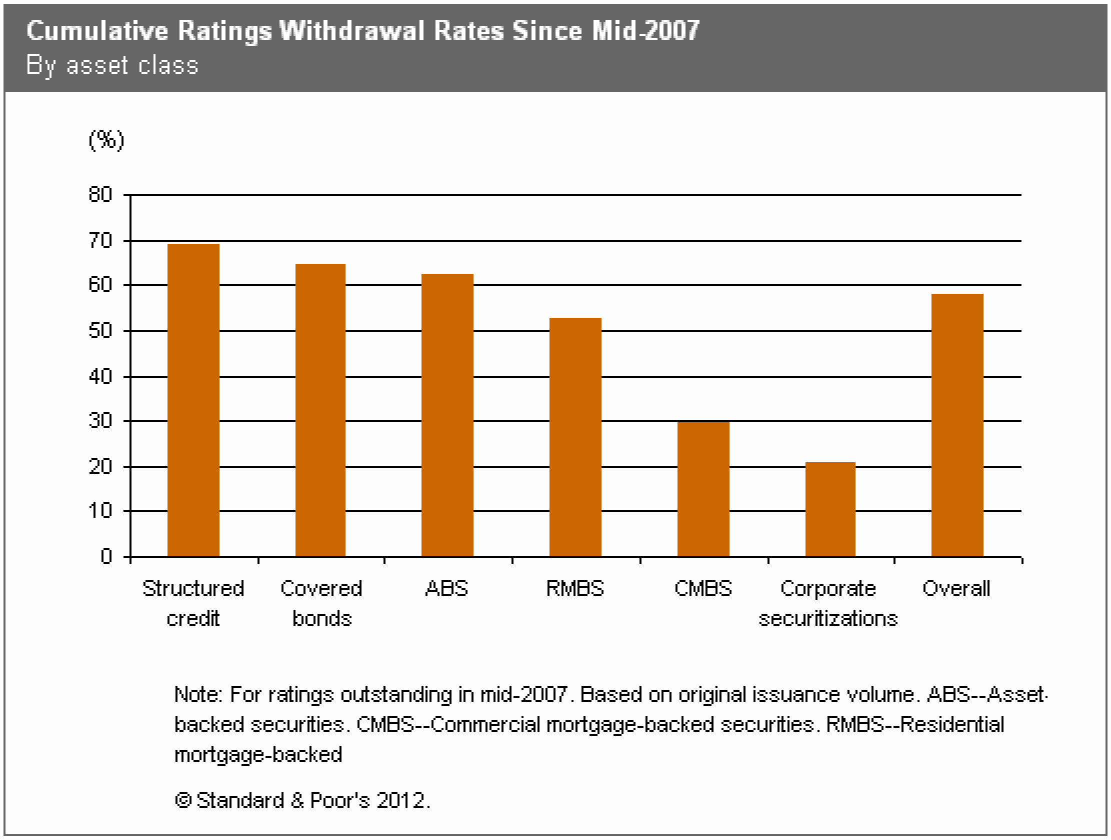


Chart 7



On May 31, 2012, we published our updated methodology and assumptions for counterparty risk (see "Counterparty Risk Framework Methodology And Assumptions"). We expect limited impact on outstanding ratings.

The outlook for ratings migration is mildly negative, as some strong economic headwinds may affect the resilient performance of European structured finance so far, in our view. The main risk remains the increasing likelihood of a double-dip recession spreading across Europe, rather than remaining in the southern countries.

Appendix

Table 3

Mid-2007 To Mid-2012 Ratings Transition Matrix For All European Structured Finance Notes

		Rating to (%)											
Rating from	**Original issuance volume (bil. € equivalent)**	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**CC**	**D**	**Upgraded**	**Stable**	**Downgraded**
AAA	2,417.7	68.4	16.2	10.1	2.6	0.8	0.4	0.7	0.1	0.8	-	68.4	31.6
AA	164.3	8.8	58.3	10.8	4.2	3.3	1.2	9.9	0.2	3.1	8.8	58.3	32.8
A	105.9	1.4	3.2	56.0	22.0	7.8	3.4	3.4	0.8	2.0	4.6	56.0	39.4
BBB	75.3	2.8	0.4	9.2	57.0	13.1	9.6	4.6	0.4	2.9	12.5	57.0	30.6

Table 3

Mid-2007 To Mid-2012 Ratings Transition Matrix For All European Structured Finance Notes (cont.)

BB	12.7	0.1	--	1.2	3.4	47.2	26.1	13.6	1.7	6.7	4.6	47.2	48.2
B	2.6	--	--	--	--	--	43.8	50.6	0.2	5.3	0.0	43.8	56.2
CCC	0.8	--	3.0	--	--	--	--	28.1	2.5	66.4	3.0	28.1	68.9
Mid-2012 volume (bil. € equivalent)	2,779.2	1,671.3	490.0	327.5	136.2	47.9	27.1	44.5	4.0	30.7	29.4	1,858.5	891.3

Note: For ratings outstanding in mid-2007. Based on original issuance volume.

Table 4

12-Month-Rolling Ratings Transition Matrix For All European Structured Finance Notes

		Rating to (%)											
Rating from	**Original issuance volume (bil. € equivalent)**	**AAA**	**AA**	**A**	**BBB**	**BB**	**B**	**CCC**	**CC**	**D**	**Upgraded**	**Stable**	**Downgraded**
AAA	2,259.3	69.8	19.7	9.0	1.3	0.0	0.0	--	--	0.0	--	69.8	30.2
AA	414.2	4.9	56.0	24.4	11.8	1.9	0.0	0.0	--	0.9	4.9	56.0	39.1
A	281.4	1.1	5.3	79.1	10.5	3.6	0.3	0.2	--	0.0	6.4	79.1	14.5
BBB	66.7	--	2.0	7.3	70.2	14.8	2.9	2.2	--	0.5	9.3	70.2	20.5
BB	56.4	--	0.0	1.1	9.2	61.9	22.3	4.9	--	0.6	10.4	61.9	27.7
B	26.8	--	--	--	2.3	10.2	73.9	7.3	0.9	5.5	12.4	73.9	13.7
CCC	43.0	--	--	--	0.2	1.2	4.0	78.3	1.8	14.6	5.4	78.3	16.4
CC	4.8	--	--	--	--	--	--	--	56.1	43.9	--	56.1	43.9
Mid-2012 value (bil. € equivalent)	3,152.6	1,601.2	694.0	532.6	161.5	66.9	37.2	40.3	3.7	15.1	55.9	2,170.3	926.4

Note: Based on original issuance volume.

Related Criteria And Research

- European CMBS Monthly Bulletin (July 2012): Downgrades Persist With Deteriorating Loan Performance, July 31, 2012
- European CMBS Monthly Bulletin (June 2012): Can German Multifamily Housing Rise To The Refinance Challenge?, July 2, 2012
- Few European Structured Finance Defaults, Despite Weak Macroeconomic Backdrop, June 29, 2012
- Counterparty Risk Framework Methodology And Assumptions, May 31, 2012
- Various Rating Actions Taken On 98 Tranches In 85 Spanish Securitizations Following Sovereign Downgrade, May 8, 2012
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- European Structured Finance Cumulative Default Rate Since Mid-2007 Remains Below 0.5%, May 17, 2010
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- Understanding Standard & Poor's Rating Definitions, June 3, 2009

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