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# Seven Years On, The Cumulative Default Rate For European Structured Finance Is Only 1.6%

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# Seven Years On, The Cumulative Default Rate For European Structured Finance Is Only 1.6%

Only 1.58% (by original balance) of European structured finance notes rated by Standard & Poor's Ratings Services—and outstanding in mid-2007—had defaulted by mid-2014. By contrast, more than two-thirds of the outstanding securities had fully redeemed.

The 12-month rolling European structured finance default rate continued to fall in the first half of 2014 to reach 0.16% by mid-year, from 0.24% in Q4 2013. This is the lowest level since Q1 2010.

**Overview**

- Only 1.58% (by original issuance volume) of European structured finance notes outstanding in mid-2007 had defaulted by Q2 2014.
- The 12-month rolling default rate dropped further to 0.16% from 0.24% in Q4 2013, while the 12-month downgrade rate stabilized at about 14.8%, partly due to some upgrades in ABS and RMBS transactions following our upgrade of Spain.
- The cumulative downgrade rate fell marginally to 34.4% in Q2 2014 from 34.7% in Q4 2013.
- Consumer-related securitizations continue to outperform those backed by corporate credit, with cumulative default rates since mid-2007 of 0.06% and 5.20%, respectively.
- Higher-rated notes outperformed those ranked lower in the capital structure, with only 1.06% of 'AAA'-rated issuance defaulting since mid-2007.
- On aggregate, 68.3% of notes that were outstanding in mid-2007 have since seen rating withdrawals—usually due to full redemption.

This report is the latest update of our regular commentary, 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 rating movements and defaults—aggregating them by the securities' original issuance volume, rather than by the number of ratings. This approach gives greater weight to higher-value securities, 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 article, we update our analysis to consider cumulative ratings movements and default rates from the beginning of the recent financial downturn—which we assume to be in mid-2007—until the end of Q2 2014. We also analyze rating changes on a 12-month rolling basis, to highlight recent trends.

## The Pace Of Downgrades Slows

Based on our calculations, only €43.5 billion of notes from an original issuance volume of €2,756.7 billion have defaulted since mid-2007, representing a 1.58% cumulative default rate at the end of Q2 2014. By definition, this cumulative default measure can only increase over time, and it rose from 1.54% in Q4 2013. The European structured finance default rate remains lower than the equivalent measure for U.S. structured finance, which is 19.30%.

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 marginally decreased to 34.4%, from 34.7% in Q4 2013. This indicates that about 65.6% of our ratings on European structured finance notes have either been stable or have risen since mid-2007. See table 3 in the appendix for a full ratings transition matrix for European structured finance in that period.

At the end of Q2 2014, the 12-month rolling default rate declined to 0.16%, its lowest level since Q1 2010. The asset-backed securities (ABS) default rate was 0.02%, followed by residential mortgage-backed securities (RMBS) at 0.10%, structured credit at 0.39%, and commercial mortgage-backed securities (CMBS) at 2.38%. Except for RMBS, the 12-month rolling default rate for these asset classes has fallen during the past six months.

At 14.8% at the end of Q2 2014, the 12-month rolling downgrade rate has slightly declined over the past six months and is now at a three-year low, primarily due to the fading effect of our European CMBS criteria roll-out and the positive knock-on effect of our upgrade of Spain (see "Ratings Raised On 62 Tranches In 48 Spanish Securitizations Following Sovereign Upgrade," published on June 5, 2014).

**Table 1**

**Summary Mid-2007 To Mid-2014 Ratings Transition, Default, And Withdrawal Rates**

**By asset class**

| | | Ratings transition rate* (%) | | | | |
|---|---|---|---|---|---|---|
| **Asset class** | **Total (bil. €)** | **Upgraded** | **Stable** | **Downgraded** | **Defaulted (%)** | **Withdrawn (%)** |
| **ABS** | 170.0 | 4.9 | 66.7 | 28.3 | 0.07 | 84.9 |
| Credit cards | 33.2 | 0.0 | 97.0 | 3.0 | 0.00 | 99.5 |
| Other consumer ABS | 68.0 | 8.9 | 61.5 | 29.6 | 0.18 | 92.3 |
| Other ABS | 68.8 | 3.4 | 57.3 | 39.3 | 0.00 | 70.5 |
| **Structured Credit** | 534.7 | 2.6 | 55.0 | 42.4 | 4.66 | 75.5 |
| Synthetic corporate | 254.4 | 3.2 | 62.6 | 34.2 | 2.88 | 93.7 |
| Leveraged loan CLO | 70.6 | 3.2 | 37.1 | 59.8 | 0.10 | 26.4 |
| SMEs | 103.0 | 0.9 | 52.9 | 46.3 | 0.55 | 72.1 |
| CDO of ABS | 28.9 | 0.4 | 10.7 | 88.9 | 41.08 | 22.8 |
| Other CDO | 77.8 | 3.5 | 65.7 | 30.9 | 6.54 | 84.8 |
| **CMBS** | 163.3 | 2.3 | 30.4 | 67.3 | 10.66 | 50.3 |
| **Corporate securitizations** | 47.9 | 1.4 | 53.8 | 44.8 | 0.17 | 28.8 |
| **Covered bonds** | 1,085.0 | 0.3 | 77.7 | 22.0 | 0.00 | 71.1 |
| **RMBS** | 756.0 | 0.9 | 58.9 | 40.2 | 0.14 | 61.8 |
| All consumer | 1,942.2 | 0.8 | 70.1 | 29.1 | 0.06 | 68.7 |
| All corporate | 814.5 | 2.6 | 50.2 | 47.2 | 5.20 | 67.3 |
| **Overall** | 2,756.7 | 1.3 | 64.2 | 34.4 | 1.58 | 68.3 |
| Overall U.S. | 5,814.5 | 1.3 | 40.2 | 58.5 | 19.30 | 42.6 |

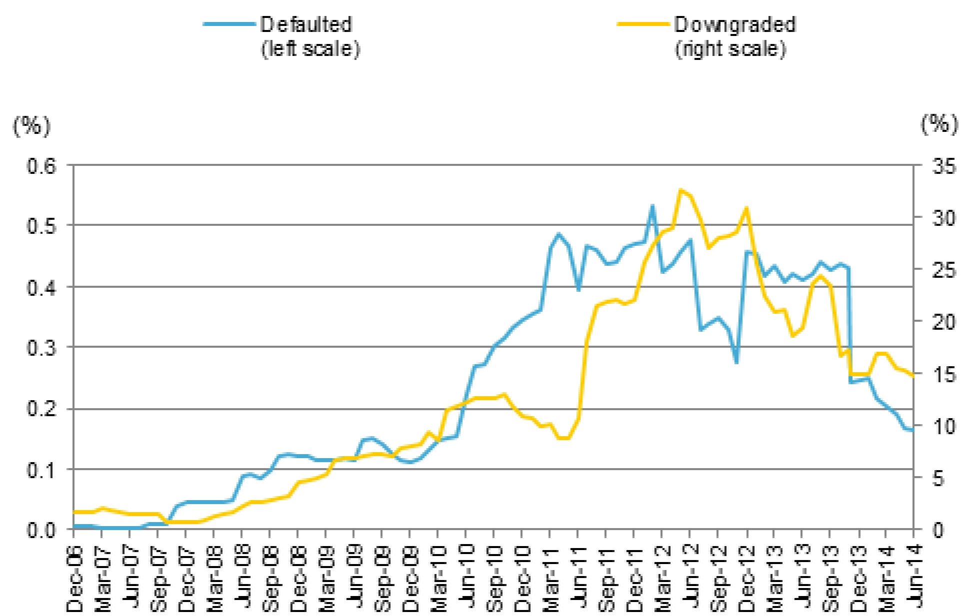
**Table 1**

**Summary Mid-2007 To Mid-2014 Ratings Transition, Default, And Withdrawal Rates (cont.)**

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 1**

**12-Month Rolling Default And Downgrade Rates**




Note: Based on original issuance volume.



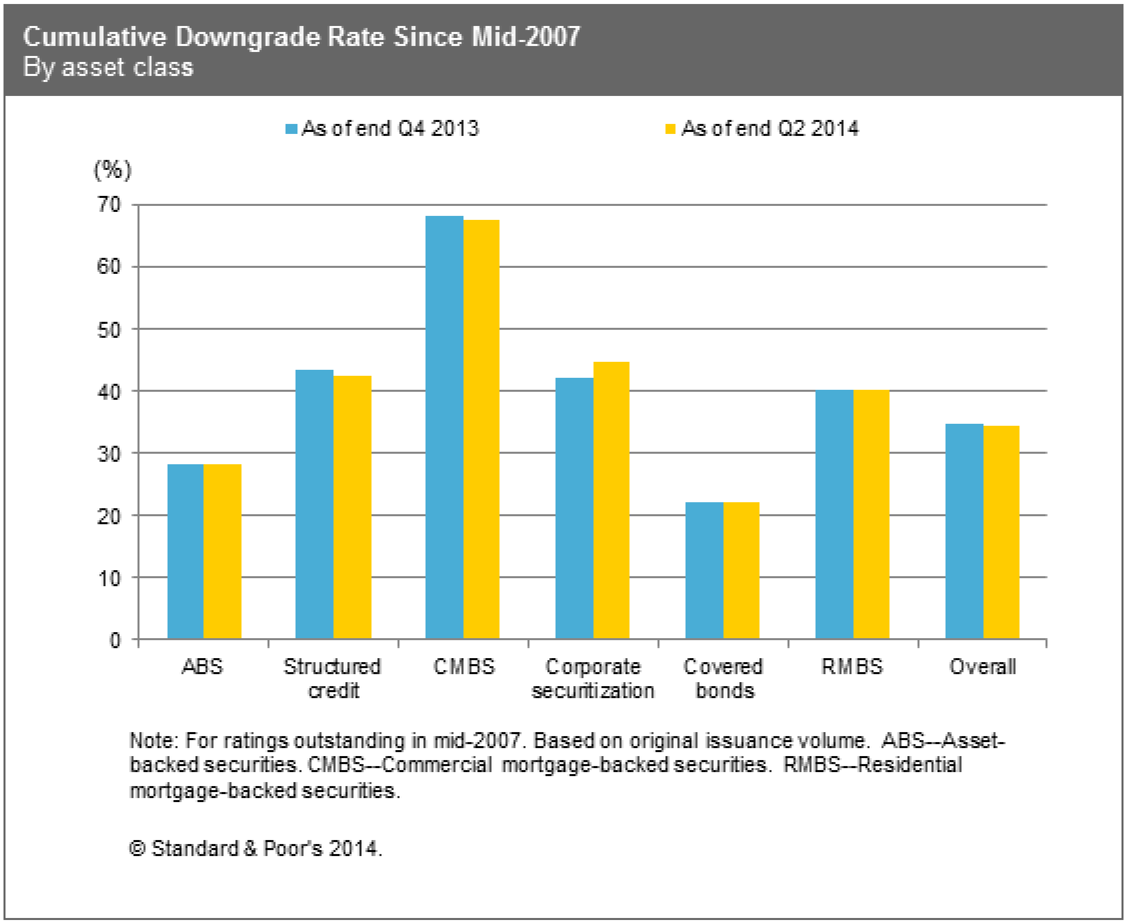
## Consumer-Related Asset Classes Continue To Outperform Corporate Asset Classes

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

- Consumer: RMBS, covered bonds, and consumer ABS; and
- Corporate: Corporate securitizations, structured credit, CMBS, and some other ABS.

When considering these classifications, consumer transactions have outperformed corporate transactions—with a cumulative default rate of 0.06% and a cumulative downgrade rate of 29.10%. This compares with 5.20% and 47.20%, respectively, for corporate transactions (see table 1 and chart 2).

**Chart 2**




The overall cumulative downgrade rate dropped marginally to reach 34.4% at the end of H1 2014 from 34.7% in Q4 2013.

We downgraded a few consumer ABS and corporate securitization tranches, for example, in consumer loan ABS transaction Sunrise S.r.l. and Punch Taverns pub securitizations (see "Related Criteria And Research").

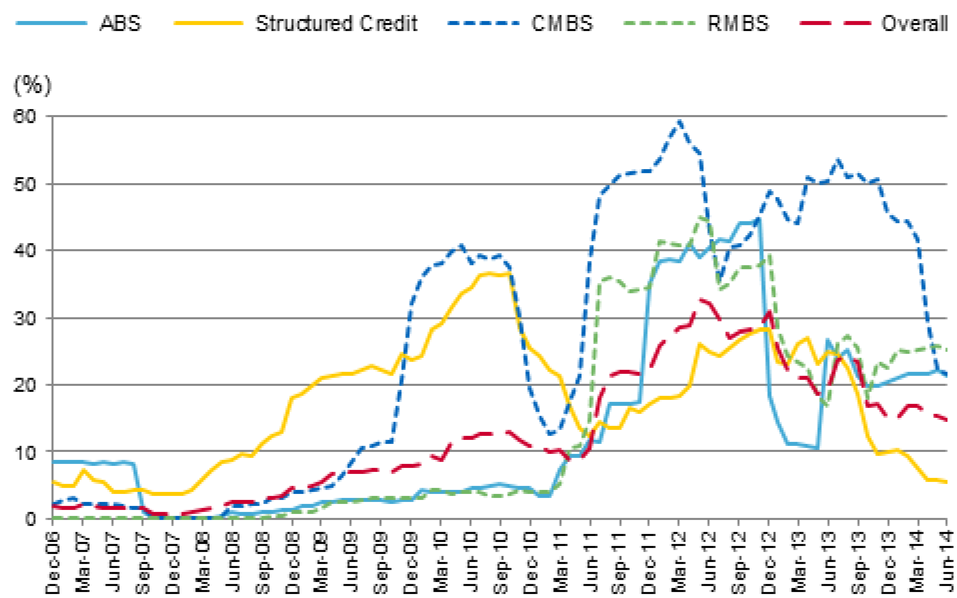
On April 15, 2014, we lowered 20 of our multi-cédulas covered bond transaction ratings (see "Various Rating Actions Taken In 28 Spanish Multi-Cédulas Covered Bond Transactions Following Review").

By contrast, the cumulative downgrade rate for leveraged loan collateralized loan obligations (CLOs) declined due to transactions' nearing maturities and amortization ('structural deleveraging').

As previously mentioned, the resultant downgrades from our CMBS criteria roll-out are gradually receding, causing the asset class' 12-month rolling downgrade rate to sharply decline.

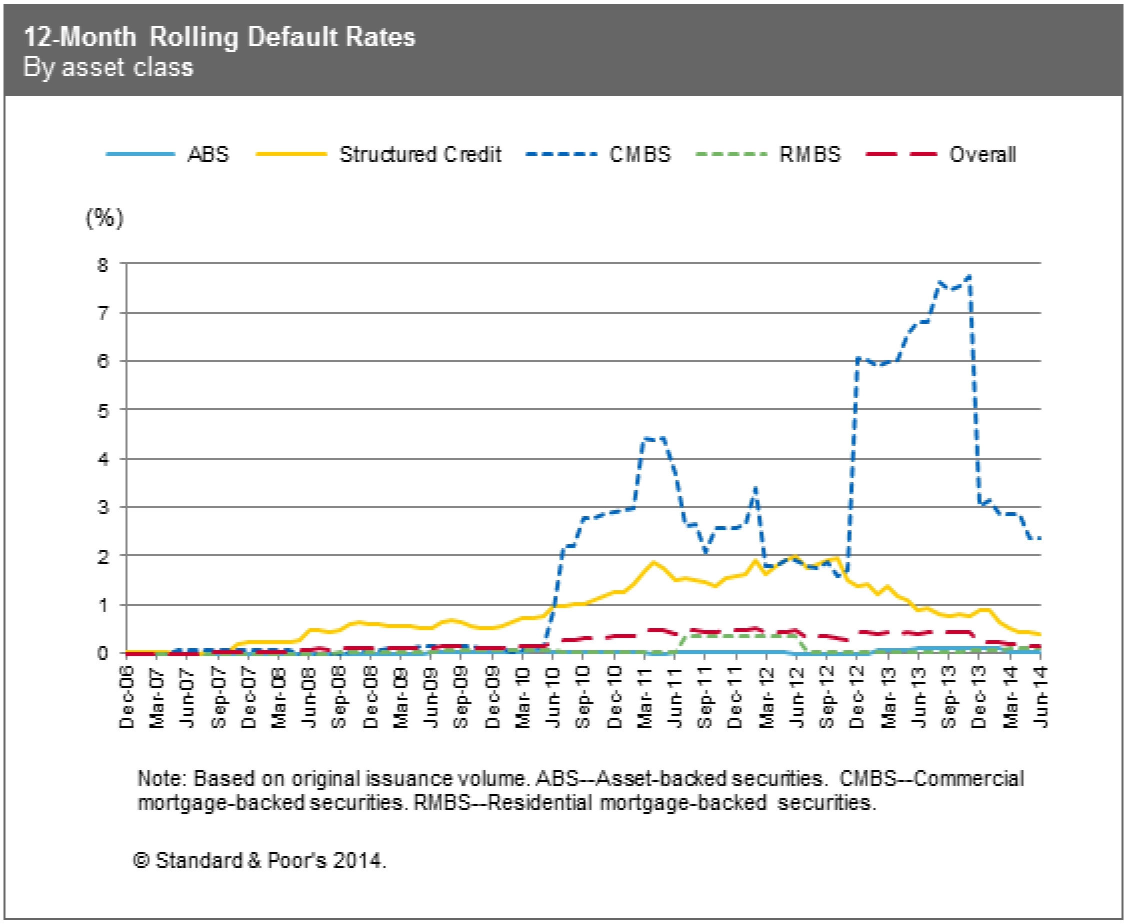
**Chart 3**

**12-Month Rolling Downgrade Rates**
By asset class




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

**Chart 4**




## One-Third Of 'AAA' Tranches 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-2014 was 83%, higher than for investment-grade notes, with the former recording a cumulative downgrade rate of 62.7%, compared with 34.3% for the latter (see table 2 and chart 5). More significantly, the cumulative default rate for speculative-grade notes, at 11.36% in the same period, has been more than seven times higher than that for investment-grade notes, at 1.53%.

This result is not surprising, in our view. 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**

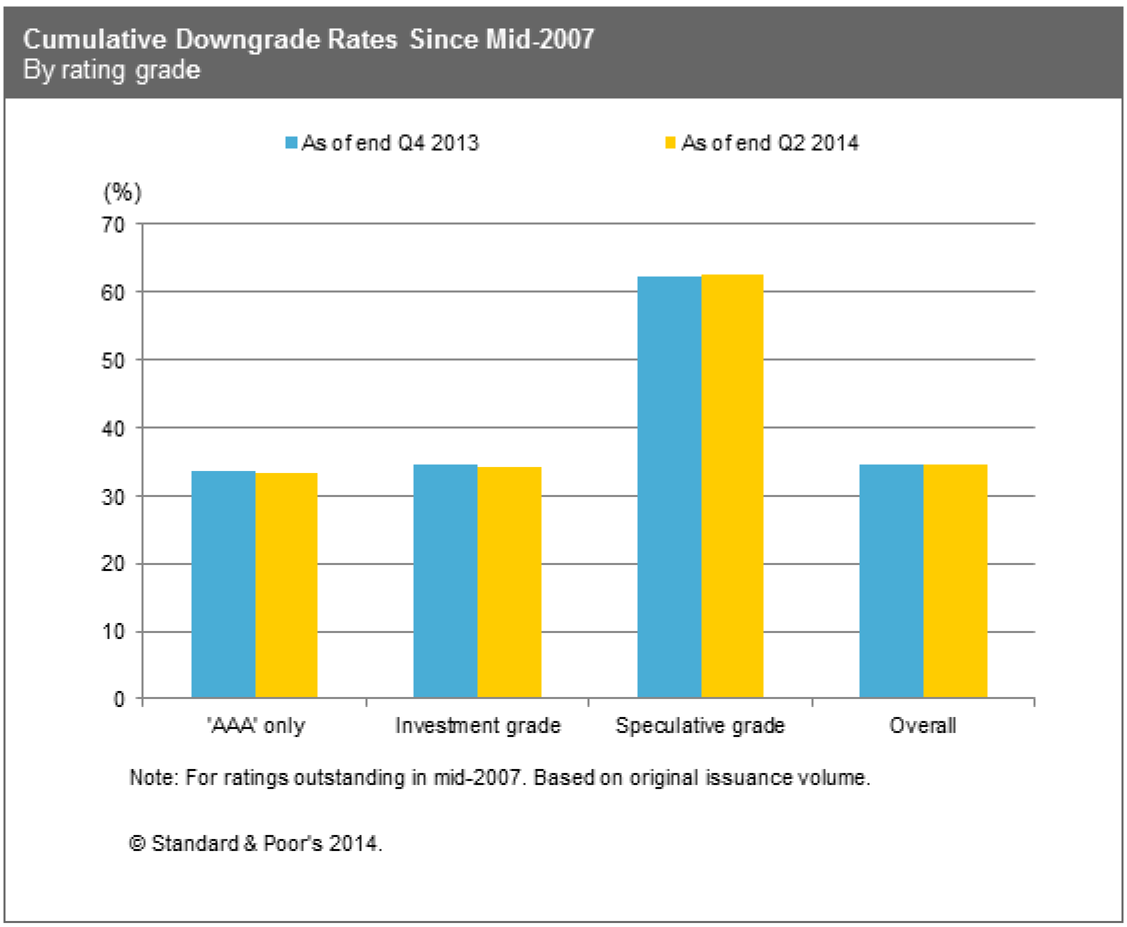
**Summary Mid-2007 To Mid-2014 Ratings Transition, Default, And Withdrawal Rates**

**By rating grade**

| | | Transition rate* (%) | | | | |
|---|---|---|---|---|---|---|
| | **Total (bil. €)** | **Upgraded** | **Stable** | **Downgraded** | **Defaulted (%)** | **Withdrawn (%)** |
| Investment-grade | 2,743.2 | 1.3 | 64.4 | 34.3 | 1.53 | 68.4 |
| Of which 'AAA' | 2,408.1 | 0.0 | 66.7 | 33.3 | 1.06 | 68.9 |
| Speculative-grade | 13.5 | 9.3 | 28.0 | 62.7 | 11.36 | 53.3 |
| Overall | 2,756.7 | 1.3 | 64.2 | 34.4 | 1.58 | 68.3 |

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**




## Close To 70% Of The Outstanding 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 fully redeemed. 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 Q2 2014, we had withdrawn our ratings on 68.3% of notes that were outstanding in mid-2007, following redemptions in more than 70% of ABS, structured credit, and covered bond programs (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). ABS, structured credit, and covered bonds report the highest cumulative withdrawal rates at 84.9%, 75.5%, and 71.1%, respectively. Withdrawals were generally for different reasons in each asset class: ABS and covered bonds traditionally have short maturities, which many of the notes outstanding in mid-2007 would now have reached. Structured credit withdrawals often followed early terminations. The CMBS cumulative withdrawal rate is comparatively low at 50.3% because many of the underlying loans' bullet maturity dates have been extended, making early repayment of the notes unlikely.

**Chart 6**

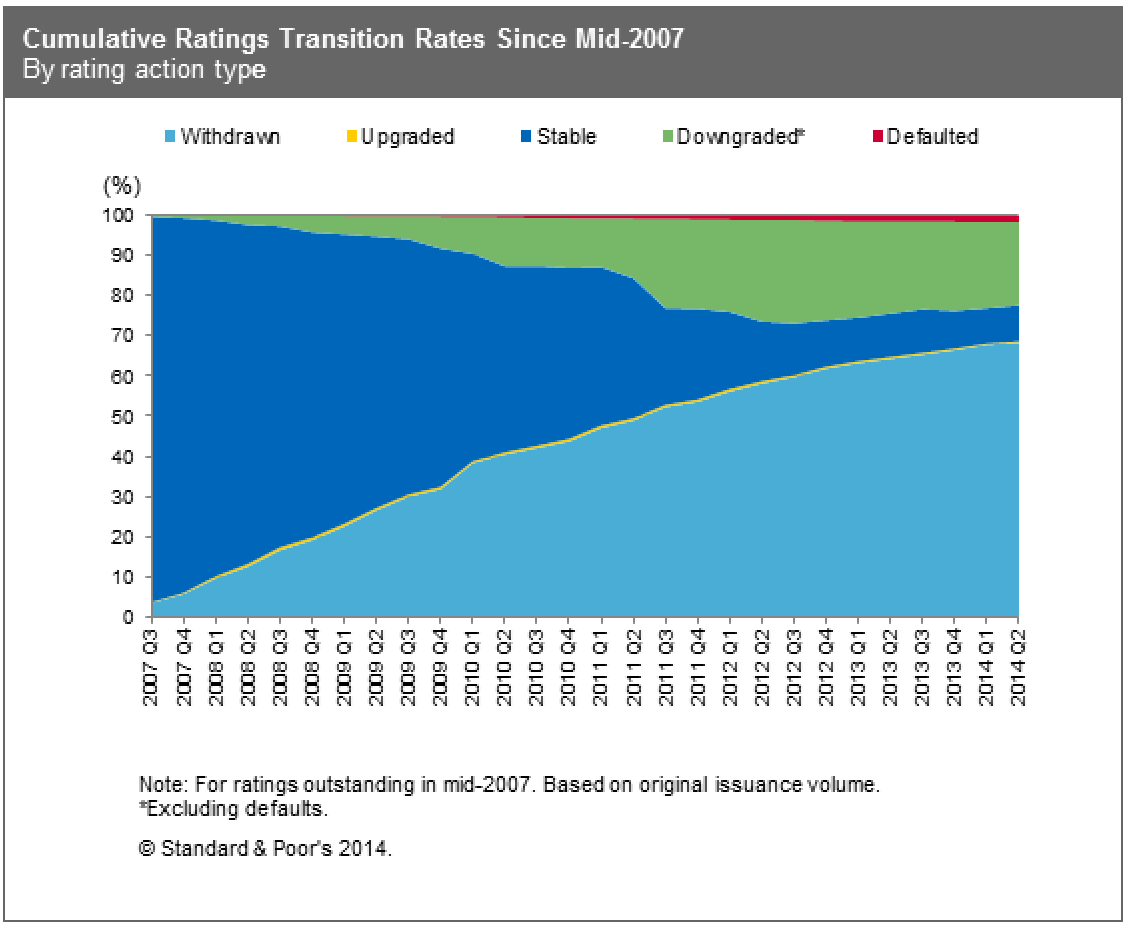
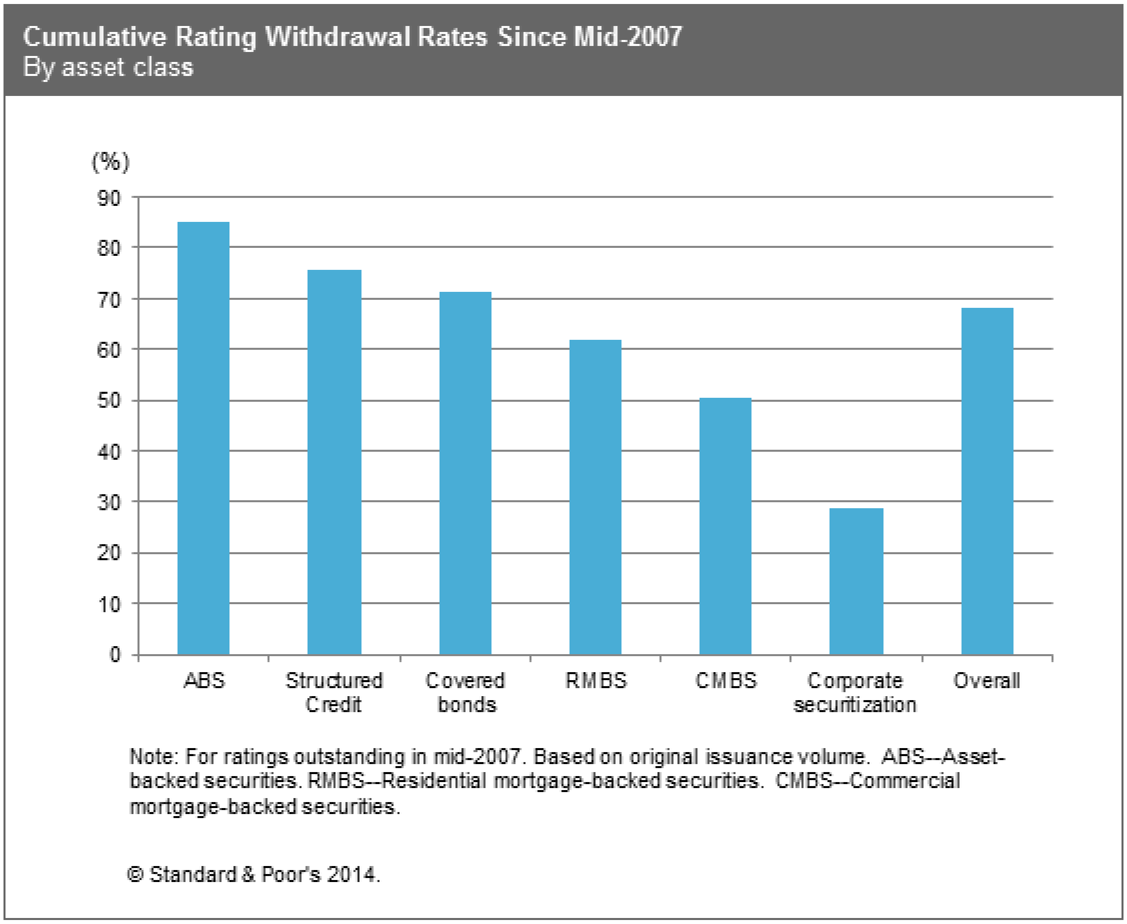


**Chart 7**




As most of Europe continues to undergo only a subdued and fragile economic recovery, Germany and the U.K. are showing greater strength. We believe that a new set of unconventional measures introduced by the European Central Bank to support Europe's economy could marginally improve the credit performance of structured finance transactions, albeit slowly (see "Credit Conditions: Europe Inches Forward On A Murky Path," published on June 9, 2014 and "European Economic Outlook: U.K. Consumers Lead The Way, While Deflation Haunts The Eurozone," published on April 25, 2014).

## Related Criteria And Research

- Low Interest Rates Are Underpinning Europe's House Price Recovery, July 28, 2014
- Ratings Lowered On Sunrise Series 1 2006 And Series 2 2007's Italian ABS Class C Notes Due To Default Ratio Increase, June 23, 2014
- Credit Conditions: Europe Inches Forward On A Murky Path, June 9, 2014
- Ratings Raised On 62 Tranches In 48 Spanish Securitizations Following Sovereign Upgrade, June 5, 2014
- Ratings On Spain Raised To 'BBB/A-2' On Improved Economic Prospects; Outlook Stable, May 23, 2014
- European CMBS Monthly Bulletin (April 2014): Outstanding CMBS Loan Balance Falls Below 50% Of Its 2008 Peak, May 19, 2014

- European Economic Outlook: U.K. Consumers Lead The Way, While Deflation Haunts The Eurozone, April 25, 2014
- Various Rating Actions Taken In 28 Spanish Multi-Cédulas Covered Bond Transactions Following Review, April 15, 2014
- Ratings Lowered And Placed On CreditWatch Negative In Punch Taverns' Pub Securitizations Punch A And Punch B, April 1, 2014
- European CMBS Methodology And Assumptions, Nov. 7, 2012
- European Structured Finance Cumulative Default Rate Since Mid-2007 Remains Below 0.5%, May 17, 2010
- Methodology: Credit Stability Criteria, May 3, 2010

## Appendix

**Table 3**

**Mid-2007 To Mid-2014 Ratings Transition Matrix For All European Structured Finance**

| | | Rating to (%) | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Rating from** | **Original issuance volume (bil. € equivalent)** | **AAA** | **AA** | **A** | **BBB** | **BB** | **B** | **CCC** | **CC** | **D** | **Upgraded** | **Stable** | **Downgraded** |
| AAA | 2,408.1 | 66.7 | 14.3 | 10.5 | 3.6 | 1.8 | 1.2 | 0.8 | 0.1 | 1.1 | - | 66.7 | 33.3 |
| AA | 166.1 | 9.0 | 58.3 | 10.2 | 2.9 | 3.5 | 2.2 | 9.4 | 0.1 | 4.3 | 9.0 | 58.3 | 32.6 |
| A | 99.3 | 1.5 | 3.4 | 53.1 | 22.3 | 4.5 | 6.2 | 4.0 | 0.6 | 4.5 | 4.9 | 53.1 | 42.0 |
| BBB | 69.7 | 3.1 | 0.5 | 5.6 | 55.4 | 11.9 | 7.5 | 8.5 | 0.7 | 6.9 | 9.1 | 55.4 | 35.5 |
| BB | 11.2 | 0.1 | - | 1.4 | 4.1 | 38.5 | 27.5 | 17.5 | 2.2 | 8.7 | 5.6 | 38.5 | 55.9 |
| B | 1.8 | - | - | - | - | 0.2 | 23.6 | 72.9 | 0.8 | 2.6 | 0.2 | 23.6 | 76.2 |
| CCC | 0.6 | - | 4.0 | - | - | - | - | 6.1 | 3.2 | 86.7 | 4.0 | 6.1 | 90.0 |
| Ending original issuance volume (bil. € equivalent) | 2,756.7 | 1,624.6 | 445.3 | 325.5 | 153.3 | 67.3 | 46.5 | 46.9 | 3.7 | 43.5 | 26.9 | 1,798.9 | 930.8 |

**Table 4**

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

| | | Rating to (%) | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Rating from** | **Original issuance volume (bil. € equivalent)** | **AAA** | **AA** | **A** | **BBB** | **BB** | **B** | **CCC** | **CC** | **D** | **Upgraded** | **Stable** | **Downgraded** |
| AAA | 1,207.3 | 93.4 | 5.0 | 1.6 | - | 0.0 | - | - | - | - | - | 93.4 | 6.6 |
| AA | 486.4 | 1.8 | 92.2 | 5.9 | 0.2 | - | - | - | - | - | 1.8 | 92.2 | 6.1 |
| A | 495.2 | 0.2 | 3.0 | 93.7 | 2.8 | 0.4 | 0.0 | - | - | - | 3.1 | 93.7 | 3.2 |
| BBB | 264.7 | 0.0 | 0.9 | 16.3 | 71.4 | 11.1 | 0.3 | 0.0 | - | - | 17.3 | 71.4 | 11.4 |
| BB | 49.0 | - | 0.3 | 2.4 | 8.8 | 75.4 | 11.4 | 1.7 | 0.0 | - | 11.4 | 75.4 | 13.2 |
| B | 53.4 | 0.3 | 0.9 | 0.1 | 0.3 | 13.8 | 79.9 | 3.6 | 0.1 | 1.1 | 15.3 | 79.9 | 4.8 |
| CCC | 24.2 | - | - | - | 0.1 | 1.0 | 4.2 | 81.4 | 1.9 | 11.6 | 5.2 | 81.4 | 13.5 |
| CC | 3.4 | - | - | - | - | - | - | - | 76.0 | 24.0 | - | 76.0 | 24.0 |

**Table 4**

**12-Month Rolling Ratings Transition Matrix For All European Structured Finance (cont.)**

| | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Ending original issuance volume (bil. € equivalent) | 2,583.7 | 1,136.8 | 526.7 | 556.3 | 208.0 | 76.0 | 50.1 | 22.5 | 3.1 | 4.2 | | 84.8 | 2,330.3 | | 168.7 |

Note: Based on original issuance volume. To Q2 2014.



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