New Issue Rating Report

# SME Initiative Uncapped Guarantee Instruments – Spain

SME Structured Finance

www.scoperatings.com

## RATINGS

| Risk cover | Rating | Notional (EUR m) | Notional (% of total risk cover) | Credit enhancement (% of total risk cover) | Premium | Final maturity |
|---|---|---|---|---|---|---|
| Senior | $AA_{SF}$ | 1,641.8 | 65.9 | 34.1 | Confidential | 31 December 2033 |
| Upper Mezzanine | $BBB+_{SF}$ | 124.3 | 5.0 | 29.2 | Confidential | 31 December 2033 |
| Middle Mezzanine | Not rated | 13.8 | 0.5 | 28.6 | Confidential | 31 December 2033 |
| Lower Mezzanine | Not rated | 82.8 | 3.3 | 25.3 | Confidential | 31 December 2033 |
| First Loss Piece | Not rated | 630.2 | 25.3 | 0.0 | Confidential | 31 December 2033 |
| **Total risk cover** | | **2,492.9** | | | | |

Scope's analysis is based on the portfolio dated 31 December 2016, provided by the European Investment Fund. Scope's Structured Finance ratings constitute an opinion on the relative credit risks and reflect the expected loss associated with the payments contractually promised by an instrument on a particular payment date or by its legal maturity and the risk to make a payment under the respective guarantee agreement. See Scope's website for the SF Rating Definitions.

**Rated issuer**

| | |
|---|---|
| Purpose | Risk transfer |
| Guarantor | European Investment Fund |
| Originator | Multiple |
| Asset class | SME Structured Finance Transaction |
| Reference assets | EUR 4,985.8m (initially EUR 5,522.4m) |
| Risk Cover notional | EUR 2.492.9m |
| Closing date | 26 January 2015 |
| Legal final maturity | 31 December 2033 |
| Payment frequency | Quarterly |
| Payment dates | 15 Mar, 15 Jun, 15 Sep, 15 Dec |

**Transaction profile**

The SME Initiative Uncapped Guarantee Instruments (SIUGI) for Spain is a risk sharing transaction of Spanish SME credit rights (i.e. loans, revolving lines and financial leasing). The reference assets (credit rights) are originated by nine Spanish banks participating in the SME initiative for Spain, which is managed by the European Investment Fund (EIF). The EIF enters into bilateral guarantees with each participating bank. The European Investment Bank (EIB), the EIF, the European Union, and the Kingdom of Spain are providing the risk covers in this transaction.

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## Rating rationale (summary)

The ratings reflect the legal and financial structure of the transaction; the credit quality of the underlying portfolio in the context of the macroeconomic conditions in Spain; the ability and incentives of the nine originators participating in the SME initiative and servicing their nine respective reference sub-portfolios, the management capacity and supervisory authority granted to the EIF as transaction manager. The rating also takes into account the counterparty credit risk exposure to the nine originating banks upon the recovery of defaulted assets, as well as to Banque et Caisse d'Epargne, Luxembourg as the account bank and paying agent.

The rating on the Senior Risk Cover is driven by its 34.1% credit enhancement, which strongly protects the risk cover against credit losses, as well as by the benefits from its sequential amortisation. The rating on the Upper Mezzanine Risk Cover reflects the lower credit enhancement of 29.2% and the instrument's larger exposure to Spanish economic uncertainties beyond Scope's outlook (credit enhancement available as of December 2016).

The ratings are driven by the characteristics of the reference portfolio, which is still under ramp-up. Scope estimates the reference portfolio's credit quality to be commensurate with B- credit quality, incorporating assumptions for the EUR 2,501.7m portion of the portfolio which is not yet ramped-up. These assumptions reflect Scope's view of the incentives the nine originators have to assign higher-risk assets to the reference portfolio within the limits of the transaction's eligibility criteria, a result of the 55 bps guarantee fee paid by each originator to benefit from the SIUGI. Scope believes this initiative supports more abundant lending towards obligor categories whose higher-risk profile would typically limit banks' lending capacity. As a result Scope expects the average portfolio quality in this transaction to be generally worse than in traditional cash SME securitisations in Spain.

The portfolio eligibility criteria allow for minimum maturities of two years and maximum maturities of 12 years, resulting in a weighted average portfolio life of 3.5 years under 0% prepayments for the assumed fully ramped portfolio. The relatively short life reflects positively on Scope's expected credit performance for the collateral pool, given the still-positive short-term outlook on the Spanish economy. However, the current credit expansion in Spain, the slowdown of the economic recovery, and the uncertainties affecting the outlook for the Spanish economy over the long-term are incorporated in Scope's assumptions.

The counterparty risk for the rated risk covers regarding recovery proceeds from the originating banks is mitigated by i) the credit enhancement from subordination and the sequential risk cover amortisation, ii) the ability to terminate the bilateral guarantee agreement upon an originator's default, through which the risk-takers' exposure to that originator's portfolio is effectively cancelled, and iii) the netting of collected recoveries with new defaults.

## RATING DRIVERS AND MITIGANTS

| Positive rating drivers | Negative rating drivers and mitigants |
|---|---|
| **Credit enhancement.** The Senior Risk Cover and the Upper Mezzanine Risk Cover benefit from a credit enhancement of 34.1% and 29.2%, respectively. The levels support the ratings in the light of the reference assets' risk profile. | **Flexible eligibility criteria and originator incentives.** The asset eligibility criteria offer the originators substantial flexibility in selecting higher-risk assets. Originators also have incentives to include higher-yielding (high expected loss) assets in order to amortise the guarantee cost paid to the EIF. |
| **Spanish economy.** The Spanish economy continues to improve, which will benefit the Senior Risk Cover and the Upper Mezzanine Risk Cover with their expected weighted average lives of 2.4 years and 4.9 years respectively, under a 0% conditional prepayment rate. | **Asset credit quality.** Scope assumes the average credit quality of the fully ramped portfolio to be commensurate with B-, reflected in the high lifetime default rate and default volatility assumptions. |
| **Alignment of interests.** Each originator must maintain a minimum economic interest of 20% in each individual credit right assigned to the SME initiative. This mitigates moral hazard and adverse origination practices. Claims on recoveries are enforceable beyond the maturity of the transaction, as part of the 'survival rights'. | **Partially ramped portfolio.** A material proportion of the underlying portfolio has not yet been ramped-up, which exposes the transaction to uncertainties regarding the portfolio's ultimate asset characteristics. This risk is only partially mitigated by asset eligibility criteria. |
| **Operational supervision.** The EIF and the risk-takers benefit from significant contractual supervision rights. This includes the ability to scrutinise credit policy applications and directly monitor originators' operations, which mitigates the risk of originators deviating from standard procedures. | **Thin Upper Mezzanine Risk Cover.** The reduced thickness of the Upper Mezzanine Risk Cover exposes risk-takers to a significant loss severity in the event of extreme scenarios that cause the tranche to default. The expected loss on the tranche is however commensurate with the assigned rating. |

| Positive rating-change drivers | Negative rating-change drivers |
|---|---|
| **A better-than-expected asset portfolio** at the end of the ramp-up period and better-than-expected performance of the assets are two key factors that could positively impact the ratings. | **Worse-than-expected performance of the assets**, such as a material increase in default rates, is one of several factors that could negatively impact the ratings. |
| **A fast recovery of employment in Spain** to historical lows would lower the base case default rate used in the analysis. However, Scope expects this recovery to be very slow. In addition, there is the permanent risk of a new recession until deeper fundamental reforms are tackled in Spain that address public spending and fiscal pressure in general, and the labour market in particular. | |
| **Faster-than-expected portfolio amortisation**, due to high prepayments, will reduce risk-taker's credit risk exposure faster than anticipated, which may positively impact the ratings. | |

## Related reports

SME ABS Rating Methodology, dated June 2017.

Methodology for Counterparty Risk in Structured Finance, dated August 2016.

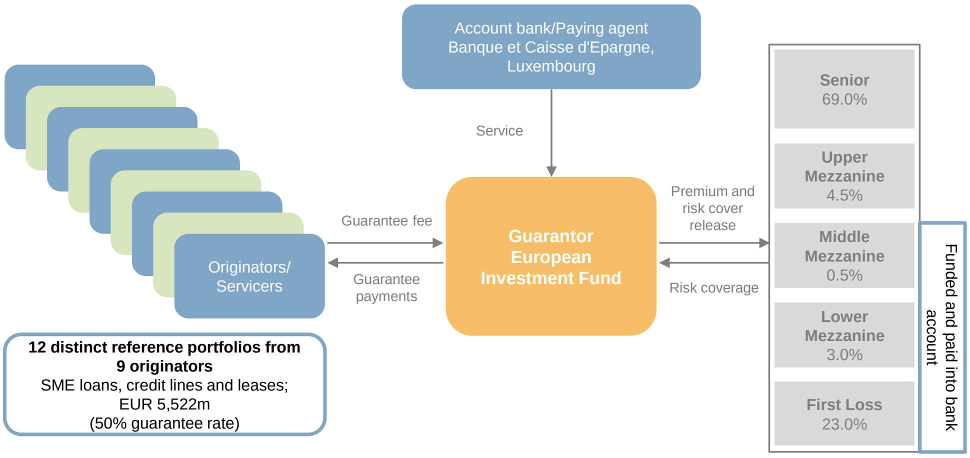
General Structured Finance Instruments Rating Methodology, dated August 2016.

## Contents



## TRANSACTION SUMMARY

Figure 1 Simplified transaction diagram[1]




The SME Initiative Uncapped Guarantee Instruments (SIUGI) for Spain is a risk sharing transaction of Spanish SME credit rights (i.e. loans, revolving lines and financial leasing). The reference assets are originated by nine Spanish banks participating in the SME initiative for Spain, which is managed by the European Investment Fund (EIF). The EIF enters into bilateral guarantees with each participating bank to obtain the risk exposure to the SME credit rights.

The risk-takers in this transaction are the European Investment Bank (EIB), the EIF, the European Union, and the Kingdom of Spain. The nine banks originating the credit rights and benefiting from this initiative are Banco Cooperativo Español, Banco Popular, Banco Sabadell, Banco Santander, Bankia, Bankinter, CaixaBank, Ibercaja and Liberbank.

Scope did not assign ratings to the Middle Mezzanine Risk Cover, the Lower Mezzanine Risk Cover, or the First Loss Piece in the transaction. The transaction's maturity is 31 December 2033.

## ASSET ANALYSIS

### Referenced underlying assets

The transaction references a portfolio of assets comprising loans, credit lines and leasing contracts granted to Spanish SMEs and self-employed individuals. All assets were first originated after the transaction's inception in January 2015. This portfolio is still under ramp-up and includes 12 sub-portfolios provided by the nine originators. The risk-takers in the transaction are exposed to 50% (the guarantee rate) of the portfolio, which cannot exceed EUR 5,522.4m in terms of initial principal balance. A significant part of the originated portfolio has already amortised as of December 2016. Figure 2 shows each originator's share in the total outstanding reference portfolio[2] and its ramping status. For confidentiality reasons, Scope has anonymised the originators' names.

[1] Structure as of closing, considering fully ramped portfolio.
[2] The total outstanding reference portfolio is equal to the sum of i) the ramped portfolio outstanding as of 31 December 2016 and ii) the non-ramped portfolio share up to the limit for each originator participating in the initiative.

Figure 2 Portfolio origination and ramp-up status[3]

| | Total | Bank 1 | Bank 2 | Bank 3 | Bank 4 | Bank 5 | Bank 7 | Bank 6 | Bank 8 | Bank 9 |
|---|---|---|---|---|---|---|---|---|---|---|
| Transaction share | **100.0%** | 22.2% | 18.7% | 14.9% | 14.4% | 10.6% | 5.8% | 6.0% | 3.9% | 3.4% |
| % ramped[4] | **49.8%** | 52.6% | 32.5% | 67.8% | 89.6% | 65.2% | 34.4% | 0.0% | 3.4% | 0.0% |

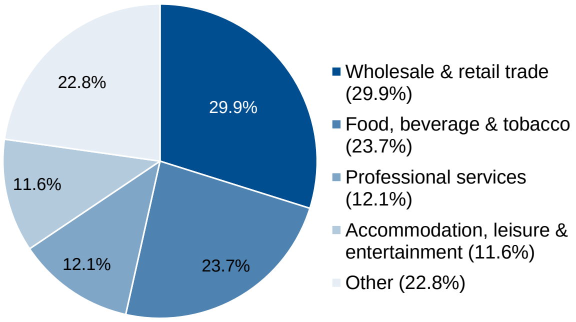
## Portfolio characteristics

### *Granular portfolio with moderate obligor concentration*

The ramped portfolio is very granular and well diversified, with the following diversity indices (DI)[5]: obligor DI 3,454; industry DI 5.5; and region DI 7.6. We do not expect granularity and concentrations to change adversely during the ramp-up, due to the transaction's eligibility criteria for the maximum single-obligor exposure and regional minimum volume targets, which is specific to each originator.

The transaction's current exposure to the Spanish real estate and construction sector is 5.3%, which is low compared to Spanish SME ABS transactions analysed by Scope.

Figure 3 Ramped portfolio distribution by industry




The current regional distribution of exposures approximately reflects the geographical distribution of GDP in Spain. We expect this distribution will change slightly because banks that have a natural footprint in less developed regions were added later to the initiative.

**Credit rights were granted under post-crisis lending standards**

The ramped part of the portfolio accounts for 49.8% of the total outstanding credit exposure, down from 54.7% originally. The reduction results from EUR 517.3m of amortisation and EUR 9.7m of defaulted exposure since inception of the transaction.

The existing assets in this portfolio are mainly amortising with a currently negligible 3.1% share of bullet exposures.

### Portfolio eligibility criteria

Assets eligible for this transaction exclude debt instruments with a credit quality below a minimum level, as measured by each originator's specific internal rating category. Considering the economics of the transaction, originators may have incentives to include higher-risk credit rights in the transaction's reference portfolio. This is because originators would want to maximise the return on the fee they paid for the guarantee.

Figure 4 Selected portfolio eligibility criteria

| | Portfolio eligibility criteria |
|---|---|
| Maturities | 2 to 12 years |
| Maximum single-obligor exposure | EUR 12.5m |
| Credit quality criteria | Max. 25% in 'B- to C' equivalent categories |

[3] Numbers represent the transaction status in terms of ramp-up, amortisation and defaults as of 31 December 2016.
[4] '% ramped' compares the reported portfolio as of 31 December 2016 against the sum of i) the reported portfolio and ii) the non-ramped portfolio.
[5] Scope analyses a portfolio's granularity before choosing the approach for modelling portfolio defaults. The granularity metric used is the diversity index with an order of diversity of two. This diversity metric is the inverse of the Herfindahl index and is applied to obligors, industries and regions. Thus, the diversity index represents the effective number of obligors, industries or regions in the portfolio, respectively.

Non-ramped portfolio assumptions reflect originators' incentives and transaction criteria

**Non-ramped portfolio: maximum maturity, reduced credit quality**

The non-ramped part of the portfolio accounts for 50.2% of the total outstanding credit exposure of the transaction.

The assets in this portfolio will also be mainly amortising; however, portfolio criteria allow up to 30% bullet exposures in the transaction, which will increase the weighted average portfolio life.

## The macroeconomic SME environment in Spain

Positive macroeconomic environment supports SMEs

The SME borrowers in this portfolio benefit from the currently positive macroeconomic environment in Spain. Support comes in the form of good availability of credit and rising domestic demand. Generally, Spanish SMEs have significantly reduced their financial leverage, making these entities stronger credits.

Scope also assumes that the observed deleveraging of Spanish corporates[6] may only partially apply to the weakest obligors. This means that the positive effect gained from the improvement of the capitalisation levels of Spanish SMEs is not as substantial for the obligors in the reference portfolios of this transaction.

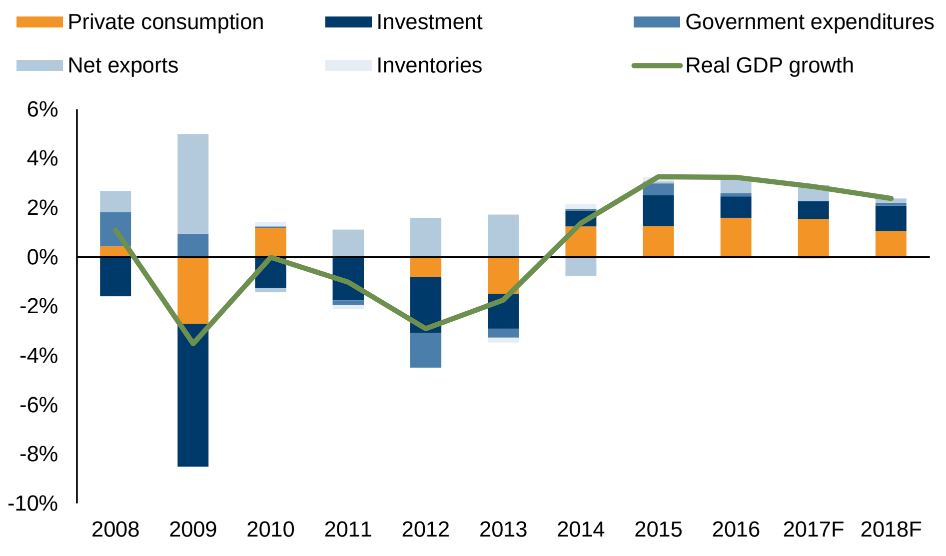
Figure 5 describes the macroeconomic environment for SMEs in Spain, which is currently very supportive. Domestic demand is robust as a result of decreasing unemployment and rising GDP. Spanish corporates benefit from the higher flexibility of the labour market due to: the correction of wages following unemployment; and, to a lesser extent, timid structural reforms.

Moreover, the international context further supports the Spanish productive sectors. The low interest rate environment and low oil prices reflect positively on input costs. A weak euro and the recovery of Spain's main European trading partners has had stabilising effects on the foreign demand for Spanish goods.

Political uncertainty could challenge economic recovery

The greatest challenges for the Spanish economy, and thus SME borrowers in the reference portfolios, reside in the political uncertainty around an unstable central government and the possible delays in the implementation of still-needed structural reforms, such as a reduction in public spending and further flexibilisation of the labour market. Both challenges represent threats to the current positive economic development and would impact weaker SMEs first.

Figure 5 Real GDP growth components




[6] Spanish corporates have reduced their indebtedness by EUR 300.5bn since 2010. This has resulted in a more resilient corporate sector that is now better able to absorb economic shocks.

## Portfolio assumptions

Scope has analysed the reference portfolio, reflecting the respective share of the nine originators, of which three have submitted to the initiative two portfolio subscriptions each, i.e. 12 sub-portfolios. Scope has derived specific assumptions for each sub-portfolio, incorporating assumptions for the ramped and non-ramped sub-share. Figure 6 shows the assumptions for each originator.

### *Fully ramped portfolio*

Scope's analysis is based on the fully ramped portfolio, considering the portfolio as of 31 December 2016. The assumptions for the non-ramped share of the portfolio reflect Scope's view on i) the originators' incentives and capabilities to assign higher-risk loans to the SME initiative's portfolio and ii) the originator-specific eligibility criteria as set by the transaction documentation.

The portfolio considered by Scope has a weighted average life of 3.5 years and a weighted average remaining term of 7.2 years. Scope will update its portfolio assumptions as the portfolio ramps up.

Figure 6 Portfolio modelling parameters per originator[7]

| | Portfolio | Ramped portfolio | | | Non-ramped portfolio | | |
|---|---|---|---|---|---|---|---|
| | | Average | Minimum | Maximum | Average | Minimum | Maximum |
| **Share in analysed portfolio** | **100.0%** | **49.8%** | | | **50.2%** | | |
| **Weighted average life (years)** | **3.5** | **3.1** | 2.4 | 4.9 | **4.0** | 2.4 | 4.9 |
| **Point-in-time lifetime default rate** | **19.0%** | **17.6%** | 14.9% | 25.4% | **20.4%** | 14.9% | 27.0% |
| **Point-in-time coefficient of variation** | **40.6%** | **38.7%** | 35.0% | 50.0% | **42.3%** | 35.0% | 71.0% |
| **Long-term-adjusted lifetime default rate** | **8.4%** | **7.65%** | 6.3% | 12.2% | **9.1%** | 6.3% | 12.2% |
| **Long-term coefficient of variation** | **76.6%** | **78.5%** | 73.0% | 80.0% | **75.0%** | 73.0% | 80.0% |
| **Base case recovery rate** | **38.4%** | **42.3%** | 24.5% | 54.0% | **35.1%** | 23.2% | 54.0% |
| **Constant prepayment rate (low)** | **0.0%** | **0.0%** | 0.0% | 0.0% | **0.0%** | 0.0% | 0.0% |
| **Conditional prepayment rate (high)** | **15.0%** | **15.0%** | 15.0% | 15.0% | **15.0%** | 15.0% | 15.0% |

NOTE: Figure 6 shows the aggregated modelling assumptions for the ramped and the non-ramped portfolio. However, Scope derived its assumptions specific to each originator's sub-portfolio.

### *Lifetime default rate analysis of the portfolio*

#### Asset default definition and stress

The guarantees stipulate that a credit event can be exercised by the respective originator upon an asset's default. Such events include '90 days overdue' delinquencies, subjective defaults, asset acceleration, and asset restructuring. The application of these definitions must follow the common practice of each respective originator.

Scope has determined that the guarantee's mechanisms and credit event definitions do not justify an additional stress on the portfolio assumptions related to default rates or recovery rates. In particular, the transaction classifies restructured loans as defaulted if their restructuring results in a loss, which is covered by the credit performance data used in the analysis.

#### Point-in-time default rate

**Default rates are calibrated on data from a period that contains significant stress**

Scope has derived the default rate assumptions for the reference portfolio using credit performance data provided by the nine originators. The data reflects the default and recovery performance of each originator for periods between 2006 and 2016, which are years containing a significant level of stress for Spanish SMEs. Scope has modelled a point-in-time lifetime default rate of 19.0%[8], with a default-rate coefficient of variation of 40.6%. These assumptions reflect the high volatility found in the default performance.

Scope considers the ramped portfolio share to have a credit quality commensurate with B over a weighted average life of 3.1 years. This results in a mean lifetime default rate of 17.6% and a coefficient of variation of 38.7%. The base case recovery rate for the ramped portfolio is 42.3%.

[7] Numbers represent the transaction status in terms of ramp-up, amortisation and defaults as of 31 December 2016.
[8] '90 days past due' lifetime default rate.

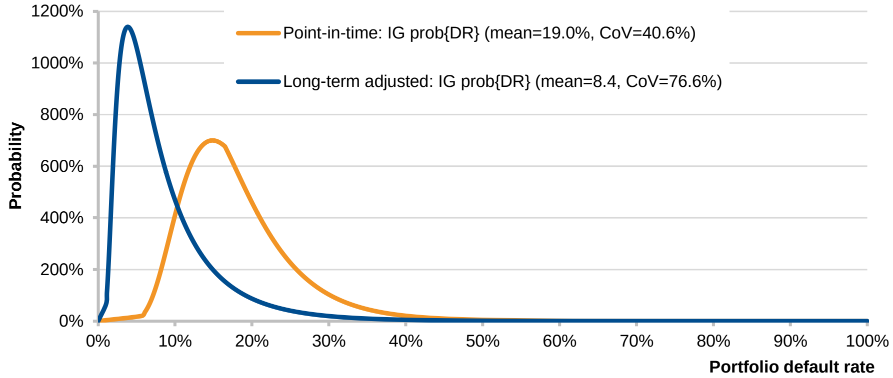
For the non-ramped portfolio share, Scope has assumed a credit quality commensurate with B- over a weighted average life of 4.00 years. Scope has also taken into account the maximum allowed maturity of an exposure (up to 12 years), as well as the originators' incentives and limitations on adding higher-risk loans to the portfolio. These assumptions result in a mean lifetime default rate of 20.4% and a coefficient of variation of 42.3%. The base case recovery rate assumption for the non-ramped portfolio is 35.1%.

### Long-term default rate adjustment

Scope incorporated a long-term default rate adjustment to analyse the credit enhancement protection of the ratings. Scope has determined that the point-in-time default rate suggested by vintage data analysis is higher than the long-term-adjusted lifetime default rate of 8.4%; and the point-in-time coefficient of variation is lower than the long-term reference of 76.6% determined for this portfolio.

Scope calibrated its long-term reference to the Bank of Spain's corporate loan delinquency data from 1993 to 2013, a period that captures a full economic cycle in Spain.

Figure 7 Point-in-time and long-term-adjusted portfolio default rate distributions




*Recovery rate*

**Recovery rate assumptions consider reference assets as 'unsecured'**

Scope has assumed a base case recovery rate for the portfolio of 38.4% with a recovery lag of 24 months. This assumption accounts for the portfolio's heterogeneous nature and the originators' varying levels of disclosure. In particular, it reflects the historical recovery rate on unsecured exposures, as derived from downturn loss-given-default data provided by most of the originators. Scope assumes that all exposures are 'unsecured', owing to limited information on additional security. In the context of this transaction, 'unsecured' means 'not secured by a mortgage', despite most of the loans having personal guarantees or other types of security that can generally reduce delinquencies or increase recoveries. Although these forms of alternative security are difficult to assess without detailed information, their impact is, however, captured in the performance references used for the analysis.

Scope applied rating-conditional stresses to the base case recovery rates and assumed a portfolio recovery rate of 26.2% for $AA_{SF}$, and 32.4% for $BBB+_{SF}$.

Figure 8 Rating-conditional haircuts and recoveries

| | AAA | AA | A | BBB | BB | B |
|---|---|---|---|---|---|---|
| Haircut | 40% | 32% | 24% | 16% | 8% | 0% |
| Portfolio recovery rate considering haircut | 23.0% | **26.2%** | 29.2% | **32.4%** | 35.3% | 38.4% |

## FINANCIAL STRUCTURE

### Capital structure and guarantee mechanics

**Sequential amortisation; loss allocation in reverse order of seniority**

The transaction comprises five instruments (the risk covers) regulated by an inter-creditor agreement. Under this agreement, the risk-takers guarantee or cash-collateralise the EIF exposures vis-à-vis the originating banks and cover a proportion of losses incurred from a reference portfolio (still under ramp-up) via payments to the EIF. The risk-takers will make these payments when losses from the portfolio exceed the credit enhancement of their respective risk covers, up to a maximum outstanding risk cover amount.

Amortisation in the reference portfolio results in the risk covers being released in order of seniority, which reduces the outstanding risk cover amounts.

Although the portfolio of originated credit rights will ultimately amount to EUR 5,522m, this transaction only transfers 50% of the portfolio's credit risk to the risk-takers; the other 50% is initially retained by the nine respective originators subscribing to this initiative[9].

The EIF obtains the credit exposure to the reference portfolio via back-to-back guarantees with the respective originating banks. Under these guarantees, the EIF reimburses the banks in cash for 50% of defaulted assets and then claims this amount from the risk-takers under a back-to-back agreement in reverse order of seniority.

If there are recovery proceeds from defaulted assets, the respective originating bank pays 50% of the proceeds to the EIF. The EIF then transfers this to write back-up credit enhancement or risk-cover notional from the transaction.

### Operational supervision

The operational integrity of the transaction is primarily ensured by the EIF's supervision of the transaction and the information rights available to the risk-takers.

The guarantees and inter-creditor agreement grant significant contractual rights to the EIF and the risk-takers, namely the ability to scrutinise credit policy applications and credit processing within each of the nine originating banks.

The consistent application of internal credit policies is a material obligation of the respective participating bank. Failure to comply could lead to the guarantee contract being terminated.

### Alignment of interests

**Risk retention and survival rights mitigate potential moral hazard**

The originators' interests are well aligned with the risk-takers' because originators must retain a minimum net exposure of 20% in every asset referenced in the transaction.

In addition, the EIF remains entitled to recovery proceeds, even after the termination of the bilateral guarantee agreement. This protects the risk-takers from default- and recovery-timing measures by the originators. The risk-takers can extend the maturity of their claims under the inter-creditor agreement with the consent of the most senior risk-taker.

## ORIGINATORS

The originators participating in the SME initiative account for more than 70% of the Spanish SME lending market. Their business models all focus on the SME sector, with the aim of benefiting from the private-sector-driven recovery of the Spanish economy. The banks are either small players with a purely domestic focus or big international banks. In Scope's view, all the banks are systemic for the Spanish economy and therefore resolvable under the Bank Recovery and Resolution Directive.

**The originators' functions, systems, processes and staff meet the required standards of Spanish SME banking**

Despite differing in sophistication, the banks' functions, systems, processes and staff meet the standards for SME lending in Spain. In addition, the banks comply with the regulatory requirements imposed and supervised by the Bank of Spain. Scope held operational review meetings with all originators and has incorporated information obtained from each bank.

### Underwriting

The nine participating banks have implemented the initiative differently in their lending programmes: some have created new products which target specific obligor groups with weaker credit quality; others continue to lend to the same pool of obligors, but provide larger loans for longer terms with reduced collateral requirements.

The current credit quality of the portfolio as presented to Scope is almost two notches below those of portfolios securitised under Spanish SME ABS transactions rated by Scope between 2014 and 2016.

[9] The minimum retained share must be 20% of each reference exposure, i.e. the originating bank cannot buy third-party protection for that share.

### Servicing and recovery

Scope views the asset servicing and management of non-performing exposures to be adequate, efficient and at the standard of Spanish SME banking. All banks include ‘subjective defaults’ in their internal default definitions, which require tight monitoring. The classification of an asset as a subjective default follows the banks’ regular practice, which is captured in the credit performance data used for the analysis. The potential to excessively use the subjective default definition is mitigated by the alignment of interests and the EIF’s entitlement to recovery proceeds from defaulted exposures, even after the guarantee has been terminated.

The originators are contractually obliged to treat the assets referenced in the transaction exactly as they would for assets in their SME lending books, that is, in line with their respective credit policies.

## QUANTITATIVE ANALYSIS

**Bespoke cash flow tool used to analyse this transaction**

Scope has applied its large homogenous portfolio approximation approach to derive the default distribution applicable to the reference portfolio. A bespoke cash flow tool was then used to analyse the transaction, reflecting the risk covers' release and loss-allocation mechanisms under the inter-creditor agreement.

The portfolio default distribution (inverse Gaussian) was combined with a cash flow analysis in order to calculate each rated instrument’s probability-weighted loss under rating-conditional recovery rate assumptions as well as its expected weighted average life.

Scope has modelled the portfolio using 12 distinct sub-groups that reflect the specific credit characteristics of each pool provided by the different originators. Scope has combined the default distribution of the sub-groups, assuming their perfect correlation.

**Scope tested the instruments against the most conservative constant-prepayment-rate assumption of 0%**

The Senior Risk Cover and the Upper Mezzanine Risk Cover were analysed with an assumption for the constant prepayment rate of 0%. Both instruments benefit from prepayments, given the absence of excess spread and their seniority in the structure. Scope also tested a constant prepayment rate of 15%, a rate commonly seen in Spanish SME securitisations.

Scope’s cumulative default-timing assumptions are shown in Figure 9. These assumptions imply the front-loading of delinquencies and a constant marginal intensity for defaults. The defaults are classified as 90+ days past due, in line with definitions in the documentation.

Figure 9 Cumulative default-timing assumptions for the reference portfolio

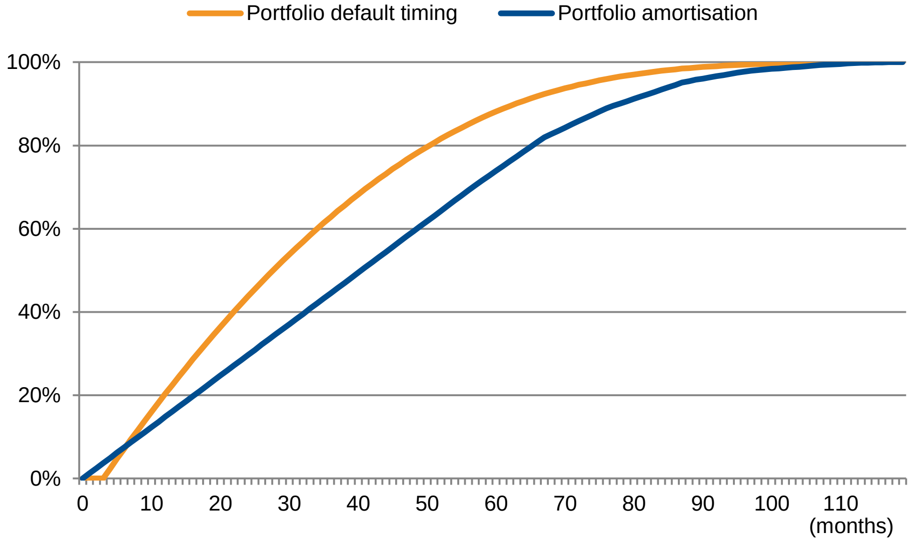
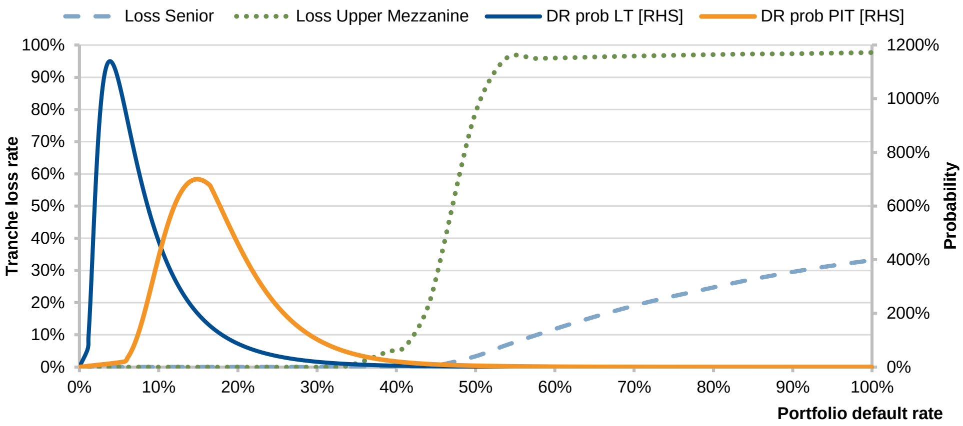



Figure 10 shows the losses of each rated risk cover at all portfolio default rates and how credit enhancement and the recovery upon asset default protect the rated instruments. The recovery explains why the Senior Risk Cover can withstand default rate scenarios beyond its credit enhancement of 34.1%. The Upper Mezzanine Risk Cover benefits from 29.2% of credit enhancement.

Senior Risk Cover can withstand losses beyond the 34.1% credit enhancement from subordination

Figure 10 Cash flow model results for base case mean DR and CoV; rating case RR




Note: DR (default rate), CoV (coefficient of variation), RR (recovery rate)

## RATING SENSITIVITY

Strong protection mechanisms of the structure support the stability of the ratings

The stability of the ratings is supported by i) the significant credit protection provided to the rated tranches and ii) Scope's use of rating-conditional recovery rate assumptions and a long-term performance reference for Spain.[10]

Scope tested the resilience of the ratings against deviations of the main input parameters: the portfolio mean default rate and the portfolio recovery rate. This analysis has the sole purpose of illustrating the sensitivity of the ratings to input assumptions and is not indicative of expected or likely scenarios. The following shows how the quantitative results for each rated instrument change when the portfolio's expected default rate increases by 50%, or the portfolio's expected recovery rate reduces by 50%, respectively:

- Senior Risk Cover: sensitivity to default rate assumptions, five notches; sensitivity to recovery rates, three notches;
- Upper Mezzanine Risk Cover: sensitivity to default rate assumptions, five notches; sensitivity to recovery rates, three notches.

## SOVEREIGN RISK

Sovereign risk does not limit the transaction's ratings

Sovereign risk does not limit any of the ratings. The risks of an institutional framework meltdown, legal insecurity or currency convertibility problems, due to Spain's hypothetical exit from the eurozone, are not material for the Senior Risk Cover rating, especially given its short expected weighted average life.

Scope factors in its positive economic outlook on Spain, as the country's GDP growth, even at a slower pace, continues. Therefore, Spanish SMEs' financial performance will likely improve further during 2017, supported by growing domestic demand and the greater availability of credit. Any challenges to this recovery are immaterial to the credit strength of the Senior Risk Cover, because of its short expected weighted average life. For the longer-running Upper Mezzanine Risk Cover, the impacts from positive economic trends could dissolve through a crystallisation of political risk as well as macroeconomic imbalances – still high public- and private-debt levels, expansionary credit availability, a still-large budget deficit, negative net investment position and very high unemployment.

## COUNTERPARTY RISK

The transaction is exposed to counterparty risk from i) the nine originators, as the recovery collectors, ii) Banque et Caisse d'Epargne, Luxembourg, the account bank and paying agent, and iii) the EIF, the manager of the transaction. In Scope's view, none of these exposures limit the maximum ratings achievable by this transaction.

[10] In the absence of an excess spread mechanism in this purely synthetic transaction, sensitivities provide superior insight compared to break-even analysis.

### Operational risk from servicers

An originator's default may expose the risk-takers to counterparty risk should the EIF have a claim to an originator relating to recovery rate proceeds from defaulted assets. The rated instruments benefit from the available credit enhancement from subordination and sequential risk-cover amortisation. Additionally, when an originator's default leads to a termination of the bilateral guarantee agreement, the risk-takers' exposure to that originator's portfolio is effectively cancelled. Moreover, the netting of collected recoveries with new defaults mitigates the size of counterparty risk exposure.

### Commingling risk from account bank and paying agent

**Commingling risk is sufficiently remote as to be immaterial for rated risk covers**

The rated tranches are exposed to the credit quality of Banque et Caisse d'Epargne, Luxembourg, the account bank, which collects the guarantee premiums and repayments of recovery proceeds from the originators. The Senior Risk Cover notes have an expected weighted average life of just 2.4 years under a 0% constant prepayment rate. Scope considers the risk of commingling losses sufficiently remote as to be immaterial for the transaction, given the high credit quality of Banque et Caisse d'Epargne, Luxembourg, as derived from public credit ratings.

The counterparty risk exposure to Banque et Caisse d'Epargne, Luxembourg was assessed using the bank's public credit ratings, which support the highest achievable rating.

The transaction benefits from a substitution trigger based on the credit quality of the bank, as measured by its public ratings.

## LEGAL STRUCTURE

### Legal framework

The guarantees are governed by English law, while the inter-creditor agreement and the EIB Senior Risk Cover agreement are governed by Luxembourg law.

Any amendments to the documentation are subject to the risk-takers' consent. Amendments to the guarantee contracts between the EIF and the originating banks that could materially impact the performance of a risk cover require a majority vote, which always includes the positive vote from the affected risk-taker. Other measures just need majority voting. Furthermore, all decisions always require the consent of the most senior risk-taker at the date of the decision

### Use of legal opinions

Scope had access to the legal opinions produced for the EIF, which provides comfort on the legally valid, binding and enforceable nature of the contracts.

## MONITORING

Scope will monitor this transaction based on the performance reports from the EIF as well as other public information. The ratings will be monitored continuously and reviewed at least twice a year, or earlier if warranted by events.

**Scope analysts are available to discuss all the details of the rating analysis**

Scope analysts are available to discuss all the details of the rating analysis, the risks to which this transaction is exposed, and the ongoing monitoring of the transaction.

## APPLIED METHODOLOGY AND DATA ADEQUACY

For the analysis of this transaction, Scope applied its SME ABS Rating Methodology, available on www.scoperatings.com.

The nine originators provided credit performance data, in the form of rating transition matrices and observed default frequency data for their internal SME rating categories, or in the form of vintage data. The data sets refer to a '90 days past due' default definition, generally consistent with the default definition under the back-to-back guarantees, and cover periods between 2006 and 2016. Recovery data was provided in the form of downturn loss-given-default data, or recovery vintages.

## APPENDIX I. REGULATORY AND LEGAL DISCLOSURES

### Important information

Information pursuant to Regulation (EC) No 1060/2009 on credit rating agencies, as amended by Regulations (EU) No. 513/2011 and (EU) No. 462/2013

#### Responsibility

The party responsible for the dissemination of the financial analysis is Scope Ratings AG, Berlin, District Court for Berlin (Charlottenburg) HRB 161306 B, Executive Board: Torsten Hinrichs (CEO), Dr Stefan Bund.

The rating analysis has been prepared by Sebastian Dietzsch, Lead Analyst. Guillaume Jolivet, Committee Chair, is the analyst responsible for approving the rating.

#### Rating history

The rating concerns newly issued financial instruments, which were evaluated for the first time by Scope Ratings AG.

#### Information on interests and conflicts of interest

The rating was prepared independently by Scope Ratings but for a fee based on a mandate of the EIB.

As of the time of the analysis, neither Scope Ratings AG nor companies affiliated with it hold any interests in the rated entity or in companies directly or indirectly affiliated to it. Likewise, neither the rated entity nor companies directly or indirectly affiliated with it hold any interests in Scope Ratings AG or any companies affiliated to it. Neither the rating agency, the rating analysts who participated in this rating, nor any other persons who participated in the provision of the rating and/or its approval hold, either directly or indirectly, any shares in the rated entity or in third parties affiliated to it. Notwithstanding this, it is permitted for the above-mentioned persons to hold interests through shares in diversified undertakings for collective investment, including managed funds such as pension funds or life insurance companies, pursuant to EU Rating Regulation (EC) No 1060/2009. Neither Scope Ratings nor companies affiliated with it are involved in the brokering or distribution of capital investment products. In principle, there is a possibility that family relationships may exist between the personnel of Scope Ratings and that of the rated entity. However, no persons for whom a conflict of interests could exist due to family relationships or other close relationships will participate in the preparation or approval of a rating.

### Key sources of information for the rating

Transaction-related contracts; operational review visits with the originators and the arranger of the transaction; and historical credit performance data indicative of the originators' loan books; and loan-by-loan portfolio information, as well as legal opinions.

Scope Ratings considers the quality of the available information on the evaluated entity to be satisfactory. Scope ensured as far as possible that the sources are reliable before drawing upon them, but did not verify each item of information specified in the sources independently.

### Examination of the rating by the rated entity prior to publication

Prior to publication, the rated entity was given the opportunity to examine the rating and the rating drivers, including the principal grounds on which the credit rating or rating outlook is based. The rated entity was subsequently provided with at least one full working day, to point out any factual errors, or to appeal the rating decision and deliver additional material information. Following that examination, the rating was not modified.

## Methodology

The methodology applicable for this rating is 'SME ABS Rating Methodology', dated June 2017. Scope also applied the principles contained in the 'Rating Methodology for Counterparty Risk', dated August 2016. Both files are available on www.scoperatings.com. The historical default rates of Scope Ratings can be viewed on the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's default rating, definitions of rating notations and further information on the analysis components of a rating can be found in the documents on methodologies on the rating agency's website.

## Conditions of use/exclusion of liability



## Rating issued by

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