Monitoring report and 2025 rating outlook

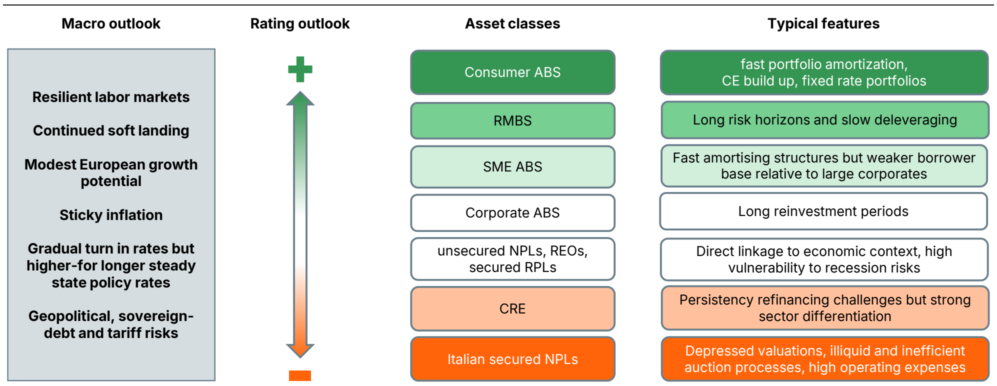
This report contains our rating outlook for the main structured finance (SF) asset classes that we rate and summarises the factors underpinning our annual transaction monitoring between October 2020 and October 2024.

Relative to the economic shockwaves experienced at the onset of the Covid pandemic, the post-pandemic period has been characterised by extremely low levels of borrower insolvencies, primarily due to the timely implementation of powerful policy measures supporting households and businesses. Consequently, asset classes such as consumer ABS, corporate and SME ABS and RMBS experienced positive ratings drift, supported by varying degrees of transaction deleveraging. Even unsecured non-performing loan ABS outperformed our initial expectations, driven by the resilience or recovery of labour markets across jurisdictions, providing a significant tailwind for re-performance rates.

The central bank rate-hiking cycle from mid-2022 to combat the inflation shock coupled with high levels of uncertainty took a heavy toll on asset classes very reliant on portfolio collateral valuations. Italian non-performing loan transactions backed by illiquid real estate saw the strongest downside ratings pressure. Instruments backed by operating commercial real estate saw negative ratings drift too, primarily driven by increased refinancing risks exacerbated by structural changes in demand for property types like office.

Figure 1 summarises our 2025 rating outlook across asset classes. A positive outlook indicates upside rating factors on our outstanding rated universe, or improved rating stability in the case of AAA rated tranches. A negative outlook indicates downside risks.

Figure 1: Asset-class outlooks



Our outlook is underpinned by our baseline expectations for a continued soft landing. Our Global economic outlook assumes resilient labour markets, modest but stable economic growth, higher-for-longer inflation and steady-state policy rates. Our outlooks for SF asset classes reflect their degree of exposure to economic risks (primarily geopolitical tensions, elevated sovereign debt levels or the imposition of US trade tariffs), as well as the rating impacts of asset-class-specific securitisation features.

Consumer and SME loan portfolios amortise, for instance, and build up credit enhancement much more quickly than mortgage portfolios under normal conditions. Corporate ABS instruments exhibit significantly longer risk horizons than SME ABS transactions because the latter tend to feature long or extended re-investment periods and, occasionally, pro-rata amortising senior tranches.

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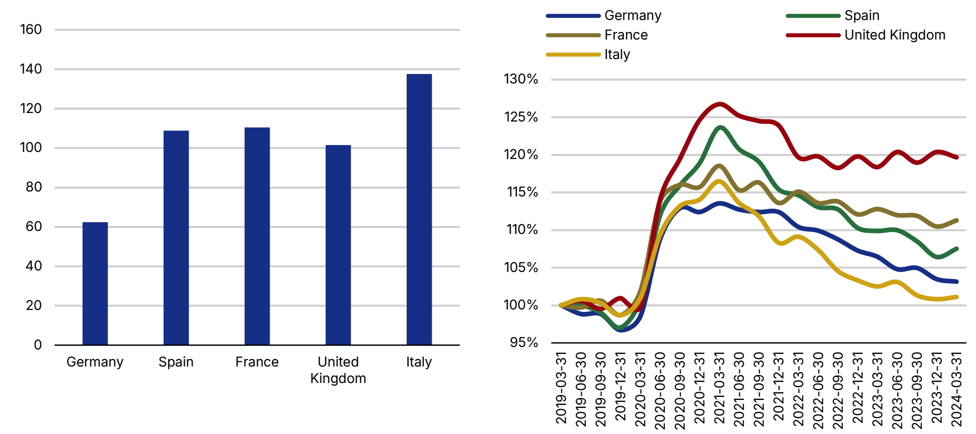
The performance of unsecured NPLs, real-estate-owned assets (REOs) and secured reperforming loans is closely linked to economic conditions and is most vulnerable to recession risk. CRE types such as office are particularly exposed, due to persistently tight refinancing conditions and challenges related to changes in demand patterns. Italian secured NPL instruments remain the most vulnerable, burdened by distressed valuations, illiquid and inefficient auction processes and the cost of carry of relatively high operating expenses.

The aftermath of the Covid crisis has demonstrated that the performance of securitisations has hinged partly on the willingness and ability of governments to provide economic life support. But large fiscal deficits in countries such as Italy and the fact that nominal government debt as a percentage of gross domestic product has still not reverted to pre-pandemic levels for the largest European economies (Figure 2) suggest that this ability may erode over time.

Consequently, high investment-grade ratings assigned by Scope do not give credit to potential government interventions as a response to the next crisis. This is primarily reflected in our underlying distressed portfolio default-rate assumptions (see illustrative example in Figure 6 below).

Figure 2: Nominal government debt as % of GDP (Q1 2024) and ratio relative to Q1 2019 (right)



Source: BIS (calculations by Scope)

The rest of this report discusses in more detail the main asset classes covered by Scope in dedicated sections:

1. Consumer ABS
2. RMBS
3. SME and corporate ABS
4. CRE instruments
5. Non-performing loan ABS

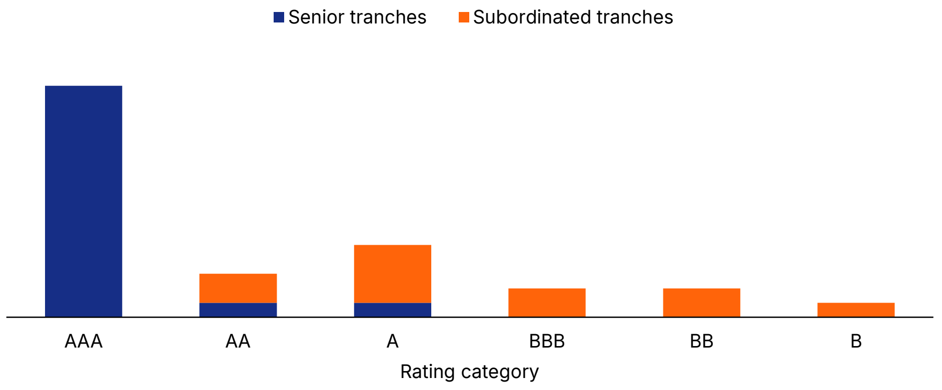
Each section follows the same structure: an overview of our coverage, a summary of our annual monitoring reviews between October 2020 and October 2024,a discussion of key factors underpinning the monitoring outcomes, and finally our asset-class-specific rating outlook for 2025.

1. Consumer ABS

Our universe of consumer ABS consists of transactions backed by Spanish unsecured consumer loans, Italian payroll-deductible loans (CQS), and vehicle loans or leases in Germany, Austria, Poland and Sweden. The current rating distribution exhibits a very high concentration of AAA ratings on senior tranches, while other tranches are distributed across the rating scale.

Very high concentration of AAA ratings on senior tranches

Figure 3: Consumer ABS rating distribution (October 2024)



Source: Scope

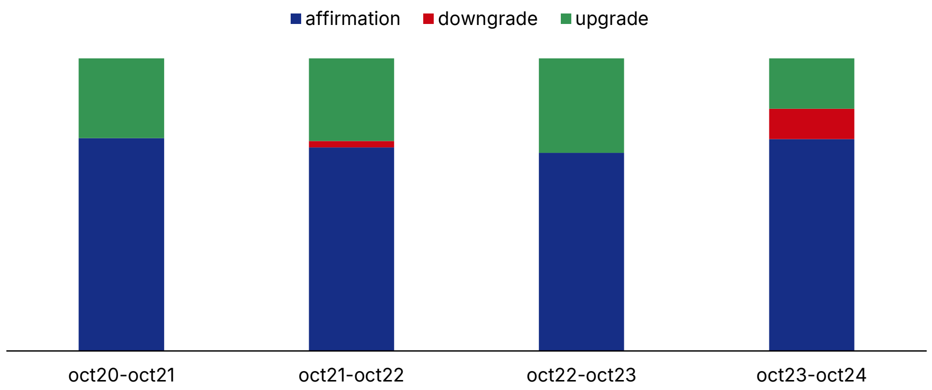
1.1 Summary of monitored ratings activity

Between October 2020 and October 2024, consumer ABS transactions experienced strong positive ratings drift, albeit the strength of the drift abated in the last 12 months of the monitoring period because a limited number of subordinated tranches were downgraded due to a variety of transaction-specific factors further detailed below.

Consumer ABS experienced strong positive ratings drift

Ratings on senior tranches exhibited significant stability by contrast: over 85% of our periodic reviews of senior tranches resulted in rating affirmations or no action, with no downgrades and almost 15% of upgrades. Meanwhile, 54% of the reviews of subordinated tranches resulted in rating affirmations or no action, 6% led to downgrades and 40% led to upgrades.

Figure 4: Consumer ABS monitoring outcome



Source: Scope

1.2 Key monitoring factors

The performance of underlying assets across all sub-segments was strong relative to our baseline assumptions. The average annual default rate across all transactions was 1.4% over the four-year monitoring period. The mean constant default rate implied by our performance assumptions was 1.8%.

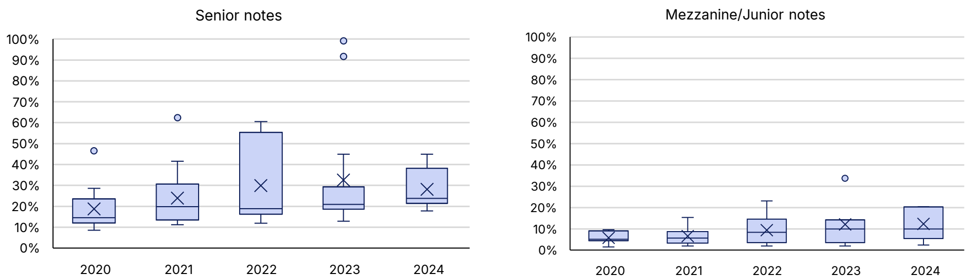
Two noteworthy factors contributed to lower-than-expected default rates. First, government-sponsored schemes supported borrowers' income after the onset of the pandemic. Second, the prevalence of fixed-rate consumer loans hedged borrowers against the rate-hiking cycle and helped combat the cost-of-living crisis. In fact, as inflation was partially passed through to higher nominal wages, borrowers' gross income to debt improved.

Disparate recovery and repayment rates

Product-specific features led to disparate recovery and prepayment rates across SF sub-asset classes. Unsecured consumer and auto loans experienced recoveries of around 20% and average annualised prepayment rates of around 7.5%. CQS exhibited much higher recoveries on default because they are insured products. Prepayments for CQS loans have a peculiar dynamic: by law CQS lenders cannot offer refinancing options to borrowers until two-fifths of the loan term has elapsed. After that, borrowers frequently exercise this option as annualised prepayments exceed 25%.

Positive rating drift was primarily driven by the combined effect of robust borrower performance, rapidly amortising portfolios, sequentially amortising tranches and effective interest-rate hedges for floating-rate liabilities. As a result, average credit enhancement ratios increased to about 30% in 2024 from 12% in 2020 for senior tranches, and to 15% from about 5% for mezzanine tranches. CQS portfolios experienced the steepest increases in credit enhancement ratios (reflected in the rising ranges of the whiskers in Figure 5) as higher prepayments drove faster portfolio amortisation.

Figure 5: Consumer ABS credit enhancement evolution[1]



Source: Scope

The very few downgrades during the 2020-2024 period were confined to transaction specific-factors and to mezzanine notes. For instance, one tranche with limited hedging was negatively affected by rising interest rates. Another downgrade was driven by a change in the transaction structure leading to re-assessment of the ratings. Another was affected by a significant migration in the composition of the underlying assets, from high-yielding short-term assets to lower-yielding, longer-term assets.

1.3 2025 rating outlook

Positive outlook on consumer ABS

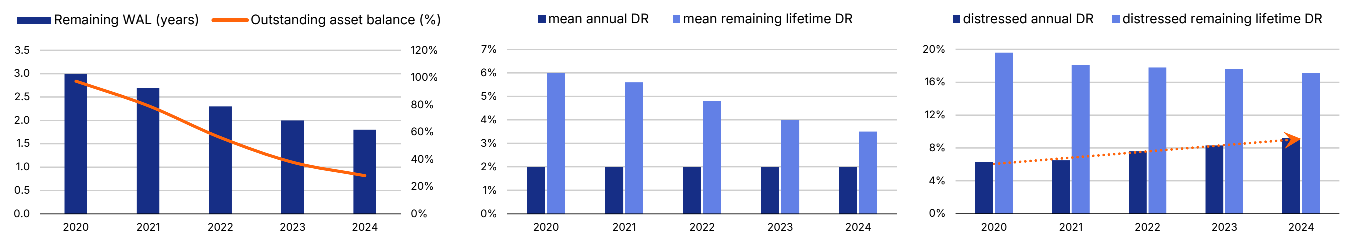
We have a positive outlook on consumer ABS, partly driven by favourable economic projections under our baseline scenario (see our Global economic outlook). This will likely support a gradual reduction of Scope's remaining mean lifetime default expectations for monitored portfolios. Our outlook is also positively impacted by a combination of asset-class-specific attributes such as relatively short risk horizons and effective interest-rate hedges.

Consumer and auto portfolios have already deleveraged to nearly half of their initial balance, and backloaded default risk associated with a concentration of weaker borrowers towards the end of portfolios' lives is low. CQS-specific risks are linked to a potential deterioration of the credit strength of either the insurance providers or the Italian sovereign, but the current ratings are resilient against such shocks. For reference, we expect that current ratings would withstand a broad-based downgrade either of insurers or of Italy of up to two-notches, equivalent to around 10-15% stress on our baseline recovery assumptions. We will continue to report on CQS performance periodically (see Italian CQS ABS report).

[1] The 'box and whiskers' plot provides a visual representation of the distribution of the data set, excluding outliers (which are shown as dots): the cross represents the mean; the divisor line in the box represents the median value, whereas the top and the bottom of the box represent the upper and lower quartiles; the whiskers represent the maximum and minimum values.

Meanwhile, our distressed modelling assumptions are designed to capture tail risks associated with a variety of factors such as geopolitical instability. To avoid excessive pro-cyclicality and to address the tail risk of heavily backloaded defaults, we are particularly prudent in adjusting distressed lifetime default-rate assumptions derived at transaction closing. As a result, implied distressed default intensities over remaining transaction lives tend to increase as portfolios season, even if past conditions were benign and lifetime default-rate expectations trend down (see Figure 6).

Figure 6: Illustrative example of default rate (DR) assumptions' recalibration



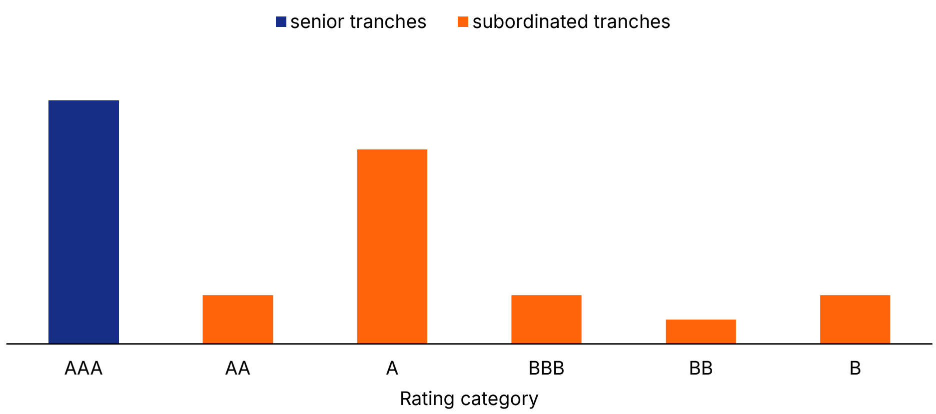
Source: Scope

2. RMBS

All senior RMBS tranches rated AAA

Our RMBS rated universe consists of transactions backed by prime and non-conforming mortgages, mainly in Spain but also in Ireland, United Kingdom, Italy and Netherlands. The current rating distribution has all senior tranches at AAA while other tranches are distributed across the rating scale.

Figure 7: RMBS rating distribution (October 2024)



Source: Scope

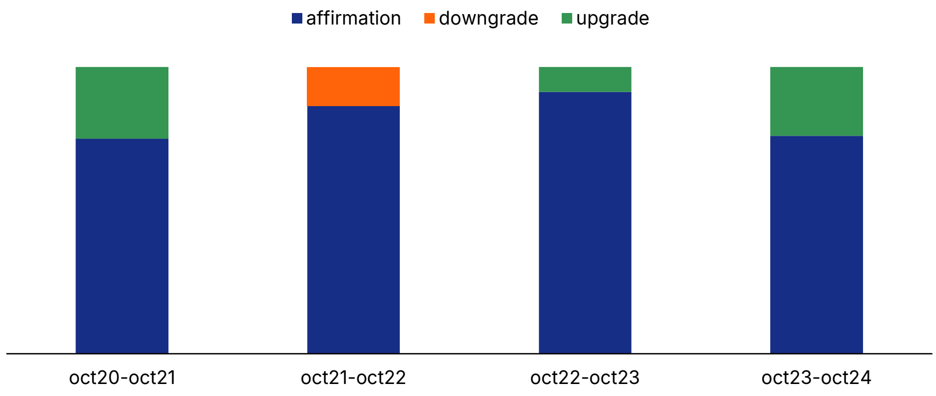
2.1 Summary of monitored ratings activity

Among the most stable SF asset classes

RMBS has been among the most stable asset classes. Of the total number of periodic reviews conducted on rated tranches between October 2020 and October 2024, approximately 83% resulted in rating affirmations or no action, 13% led to upgrades and less than 4% led to downgrades. The overall positive ratings drift was only interrupted between October 2021 and October 2022, when a few subordinated tranches were downgraded.

Senior RMBS tranches were particularly stable, with 95% of ratings unchanged and the remainder upgrades only, with no downgrades. RMBS subordinated tranches were relatively stable compared to other asset classes: 75% of our periodic reviews of subordinated tranches resulted in rating affirmations or no action, 19% led to upgrades and 6% led to downgrades.

Figure 8: RMBS monitoring outcome



Source: Scope

2.2 Key monitoring factors

Observed default ratios on prime RMBS below our modelled assumptions

Borrower performance on prime RMBS has been exceptionally strong. The average three-month arrears ratio on prime RMBS ranged between 0.1% and 0.5% between 2021 and 2024, with cumulative default ratios below 0.1% for transactions with an average seasoning of two years. Scope's modelled default distributions for standard prime RMBS assume a mean lifetime default of between 2.3% and 3.9%. Performance on non-conforming RMBS has also been very strong: no defaults occurred in the last 12 months and an average three-month arrears ratio of 1.0%. Annual prepayment rates generally ranged between 2.5% and 7.5% with a few transactions registering higher peaks as some borrowers switched their floating-rate mortgages to fixed-rate mortgages.

The strength of the RMBS asset class reflects the resilience of the European labour markets, which offset the negative impact of inflation on household balance sheets and of rate hikes on borrowers with floating-rate mortgages. Unemployment rates in most European countries have steadily declined over the past five to 10 years (e.g. Spain, Italy, Ireland), or remained low at around structural unemployment levels (e.g. UK).

The underlying collateral of European RMBS also remains strong. Over the past 10 years, house prices have grown across major European countries at average nominal annual rates of about 5%. Although house prices in some major European countries fell in 2023, the residential property price index grew in the first half of 2024 in almost all European countries and has nearly compensated for the price reductions registered in 2023.

Rating stability of senior RMBS tranches testament to strength of borrower base and collateral

The strength of the borrower base and the collateral backing underlying portfolios explains the rating stability of senior RMBS tranches, as most had already achieved the highest possible rating at closing. The limited number of upgrades of senior RMBS notes was driven by the gradual increase of credit enhancement in transactions featuring French amortising portfolios over extended periods[2], simple structures with sequentially amortising notes, and limited interest rate-risk exposure[3]. On average, credit enhancement on senior tranches has increased to 21.9% from 16.6% since closing.

The rest of the upgrades were on mezzanine tranches, partly driven by deleveraging. Some upgrades were also driven by the application of Scope's new RMBS Rating Methodology that introduced a stochastic recovery-rate distribution and a reduction in our senior cost assumption to 0.3% from 0.5%-1.0%. The downgrades in 2022 were related to sub-optimal interest-rate risk hedges on mezzanine tranches, or to the restructuring of revolving transactions resulting in riskier portfolio limits

[2] The average initial weighted average life of residential mortgage portfolios backing Scope's rated RMBS is 13 years, while the pool factor decreased on average by 25% in three years.

[3] Generally, transactions feature floating-rate assets and floating-rate liabilities or have effective interest rate swaps mitigating fixed-to-floating interest-rate risks.

2.3 2025 rating outlook

Positive outlook on RMBS thanks to resilient borrower affordability

We maintain a positive rating outlook on RMBS as we anticipate that borrower affordability will remain resilient, if not improve. This expectation is primarily driven by further expected declines in projected unemployment, supported by a modest but stable growth projection for the European economy in 2025 and beyond.

Real estate markets have proven resilient to economic shocks on the back of inflationary pressures and/or secular monetary easing policies. Furthermore, the gradual reduction in ECB rates will push credit growth above 2024 levels, entailing a new tailwind for residential house prices.

We do not anticipate a significant increase in prepayments in 2025, as average interest rates will remain high relative to those prevailing during the origination period of the underlying mortgages (2017-2022). However, as policy rates continue to decline, we will see prepayments pick up in 2026 because more borrowers will be incentivised to refinance floating-rate mortgages with fixed-rate alternatives.

Even though significant downside risks could negatively impact European economic growth expectations, such as the inflationary impacts of US tariff policy under the new administration or mounting euro area sovereign debt risks, we expect the performance of RMBS, particularly senior tranches, will remain resilient even under a severe shock. This view is primarily supported by stressed scenario analysis.

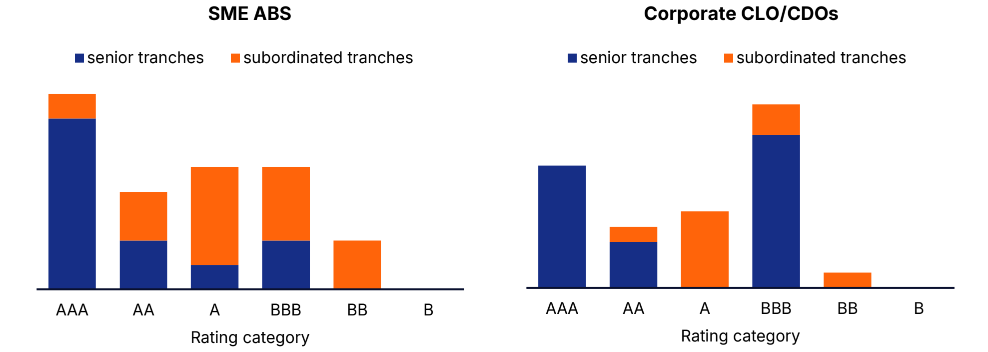
The strength of RMBS is also supported by more prudent bank underwriting standards since the global financial crisis, including stronger affordability and over-collateralisation requirements (e.g. lower DTI and LTV ratios), an increasing share of fixed-rate mortgage origination, together with better governance around property appraisal procedures.

3. SME and corporate ABS

Scope's universe of SME ABS includes transactions primarily backed by SME loans and leases, with a smaller proportion backed by commercial real estate loans. This coverage is concentrated in Spain, Italy, and France.

Scope's corporate ABS portfolio encompasses corporate loans, commercial real estate loans, project finance loans, and trade finance. Portfolios are concentrated in the UK with smaller exposures in the rest of Europe, North America and Asia. Approximately three quarters of these transactions, mostly balance sheet CLOs, are passively managed and mostly granular. For the remaining transactions, the underlying investments consist of less granular and actively managed private debt funds and co-investments.

Figure 9: SME and corporates ABS rating distributions (October 2024)



Source: Scope

3.1 Summary of monitored ratings activity

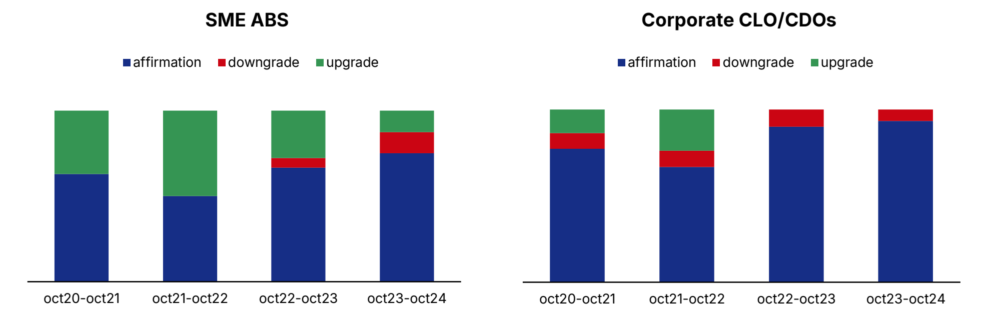
SME CLOs among the best performing asset classes 2020-24

SME CLOs were among the best performing asset classes between October 2020 and October 2024, exhibiting the highest number of upgrades (31%) and less than 5% downgrades.

Of the total number of annual periodic reviews conducted by Scope on senior tranches during the October 2020 to October 2024 period, 76% resulted in rating affirmations or no action, 20% led to upgrades and 4% led to downgrades. Meanwhile, 47% of the reviews conducted on subordinated tranches resulted in rating affirmations or no action, 47% led to upgrades and 6% led to downgrades. All downgrades took place post October 2022.

The performance of corporate CLO/CDO senior tranches was extremely stable, as all reviews conducted on senior tranches resulted in affirmations or no action. Meanwhile, 60% of the reviews conducted on subordinated tranches resulted in affirmations or no action, with the remainder equally distributed between upgrades and downgrades. However, all upgrades were concentrated prior to October 2022, while the downgrades were evenly distributed across time.

Figure 10: SME and corporates ABS monitoring outcome



Source: Scope

3.2 Key monitoring factors

Post-Covid SME and corporate loan performance better than expected

The performance of SME and corporate loans has generally been strong in the post-Covid period relative to our initial expectations. The average annual 2020-2024 default rates for a sample of standard SME ABS transactions ranged between 0.3% and 1.7%. This compares to Scope's mean constant default rate assumptions ranging from 1.1% to 3.2% for the same transactions.

The resilient business environment in Europe was primarily supported by targeted policy interventions which were pivotal in addressing firms' liquidity needs and reducing the immediate risk of insolvencies in the aftermath of the Covid-19 pandemic. For instance, the European Guarantee Fund facilitated liquidity for struggling businesses, and European banks played a vital role in extending credit supported by government-backed loan guarantees.

The European Central Bank also took longer to adjust policy rates than other major central banks and did so less aggressively, which eased pressure on debt service coverage ratios. Performance remained resilient as policy support schemes wound down, even through the rate-hiking cycle that started in mid-2022. The success of fiscal and monetary interventions was attested as the business environment has normalised.

The primary driver of SME ABS upgrades was deleveraging of senior and mezzanine tranches (i.e. a significant build-up of credit enhancement), supported by strong performance by borrowers, fully sequential amortisation structures, and natural interest-rate hedges in most transactions (i.e. assets and liabilities linked to the same type of interest). The decline in upgrades after October 2022 was driven by a shift in the rated universe towards a higher proportion of pro-rata amortising tranches, which did not benefit from fast deleveraging. The limited number of downgrades was driven by negative borrower selection in specific transactions (i.e. pools consisting of underbanked borrowers), or by the exposure of junior liabilities to unhedged interest-rate risk.

Corporate ABS featured higher rating stability relative to SME ABS, reflected in a larger share of rating affirmations. This was primarily because the deleveraging effect was less prominent, as most corporate ABS transactions remained in their ramp-up or reinvestment periods between October 2020 and October 2024. Passively managed portfolios adhered strictly to eligibility criteria and concentration limits, while over-collateralisation frequently exceeded minimum required levels in actively managed portfolios.

The relatively limited number of upgrades and downgrades in corporate ABS was driven by a variety of transaction-specific structural features such as waterfall triggers, reinvestment period extensions and increased concentration risk due to transaction downsizing.

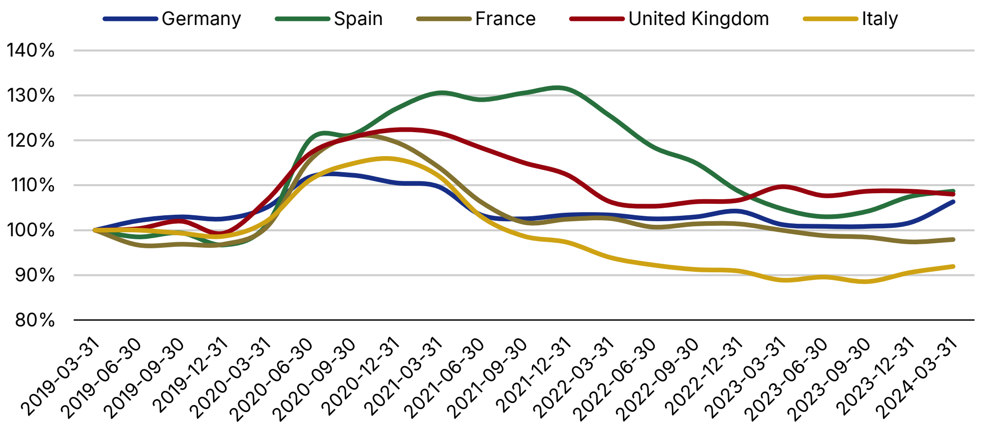
Some upgrades were driven by a switch from pro-rata to sequential amortisation following breaches of a tight performance covenant while one of the downgrades was driven by an ineffectively sized trigger, preventing a switch from pro-rata to sequential amortisation.

3.3 2025 rating outlook

Positive to stable outlook for SME and corporate ABS

The 2025 outlook for SME and corporate ABS is positive to stable, driven by our baseline scenario of a continued economic soft landing while acknowledging a variety of threats to the business environment, including higher-for-longer steady-state policy rates and economic risks. Debt service coverage ratios for non-financial corporations in most jurisdictions have picked up again, particularly pressured by rising interest rates since 2022 (see figure 11). Even as the ECB implements gradual rate cuts, this may not compensate for widening credit risk spreads.

Figure 11: Changes to debt service coverage ratios since Q1 2019 (non-financial corporations)



Source: BIS (calculations by Scope)

SME ABS structures are more vulnerable in the short term due to their weaker borrower base but underlying portfolios are mostly static and amortise quickly, which will result in enhanced credit protection in 2025 under our baseline economic scenario.

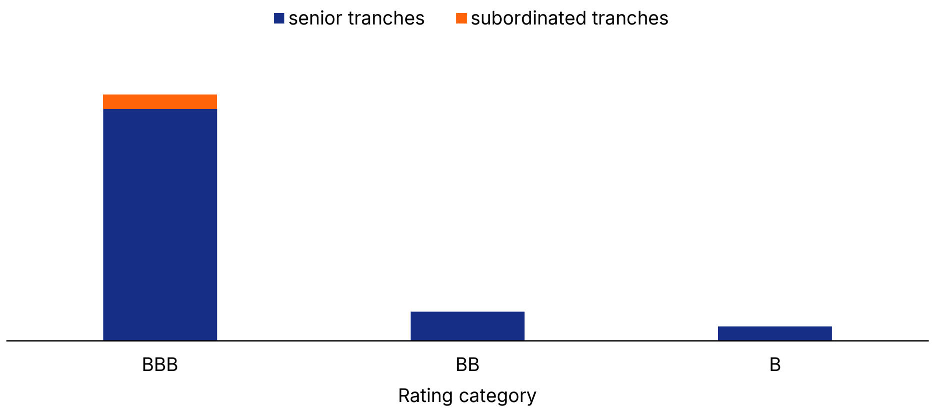
Corporate portfolios often feature extended reinvestment periods and occasionally pro-rata amortising structures, which exposes the ratings to longer risk horizons and to negative portfolio migration risk, including excessive geographical or sector concentrations. However, these risks are generally mitigated by strict eligibility criteria and portfolio covenants in passively managed portfolios, and/or by prudent reinvestment management policies.

From a securitisation structure perspective, the gradual reduction in interest rates is expected to have a limited impact since most transactions are naturally hedged from the outset. Some SME transactions with a higher proportion of fixed-rate assets and floating-rate liabilities could see some benefit while a limited number of corporate ABS with floating-rate assets and fixed-rate liabilities could experience a slight reduction in excess spread.

4. Commercial real estate (CRE) instruments

Our CRE ratings portfolio is primarily composed of senior CRE loans, with a significant concentration in the BBB rating category. The collateral primarily consists of operational real estate and some transitional real estate portfolios composed of logistics, office, residential, retail or hospitality assets. Geographically, the coverage focuses on major European economies (including Germany, the United Kingdom and France) as well as Spain, Portugal and Ireland.

Figure 12: CRE rating distribution (October 2024)



Source: Scope

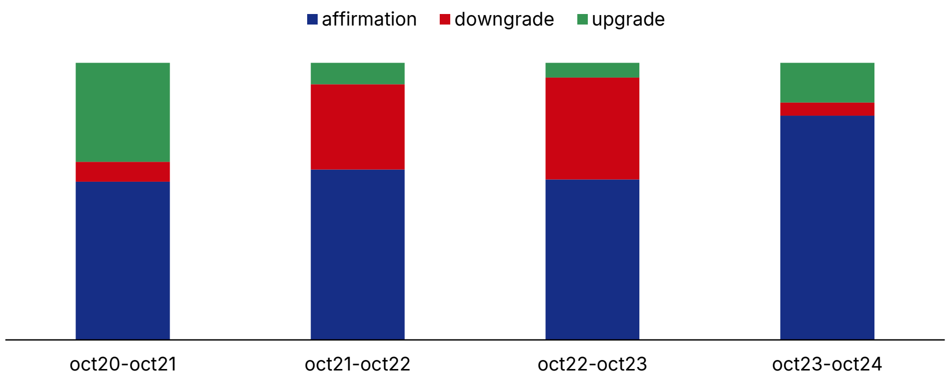
4.1 Summary of monitored ratings activity

2020-21 upgrades followed by two years of downgrades

Commercial real estate encountered significant challenges in the post-pandemic period, although overall performance has been mixed. Of the total number of annual periodic reviews conducted on rated tranches between October 2020 and October 2024, 20% resulted in rating downgrades and 15% resulted in upgrades. The remainder resulted in rating affirmations or no action.

Upgrades prevailed between October 2020 and October 2021 but that period was followed by two years with a large concentration of downgrades with only a few upgrades spread across various sub-sectors. More recently, stabilisation in interest rates and better business conditions in certain sectors have led to a significant uptick in upgrades.

Figure 13: CRE monitoring outcome



Source: Scope

4.2 Key monitoring factors

Rising capitalisation rates and refinancing risk

European commercial real estate was severely impacted by the knock on-effects of Covid-19, including muted economic growth, restricted access to credit, and rising uncertainty. This led to a widespread increase in capitalisation rates and refinancing risks. However, transaction performance varied based on sector-specific and transaction-specific factors. As a result, overall CRE ratings performance over the four-year monitoring period was mixed. Logistics and residential assets have generally maintained solid fundamentals in the post-Covid period; hospitality and retail recovered to varying degrees; the office sector continues to struggle.

Supported by low vacancy rates and inflation-linked rental income, the logistic sector's solid fundamentals have helped offset the negative effects of yield adjustments on valuations. Fundamentals have been driven by e-commerce growth, stronger demand for warehouse and distribution space due to supply-chain disruptions and limited new developments due to rising construction and interest costs.

Consequently, the rating performance of operational logistic CRE loans remained stable between October 2020 and October 2024, with most ratings unchanged, no upgrades and only one downgrade attributed to a highly geared debt facility with significant lease expiries before maturity.

Similarly, the performance of residential asset-backed instruments within our CRE universe was also very stable through the four-year monitoring period, with no upgrades or downgrades, reflecting robust market dynamics. Demand in the residential sector has increased due to a steady influx of immigrants into major European cities, while housing supply has struggled to keep up. Additionally, interest in alternative housing options such as purpose-built student accommodation and senior living has grown as demographic preferences evolve.

Hospitality-backed transactions encountered substantial initial challenges, which explains downward rating actions between October 2021 and October 2022, caused by poor hotel performance stemming from the pandemic. However, since October 2023, most of the upgrades conducted by Scope have been on hospitality-backed transactions driven by the strong recovery of tourism demand, reflected in rising occupancy levels, growth in average daily rates, and by cashflow stabilisation in newly constructed hotels.

Retail-backed transactions in our CRE universe faced downward rating pressure between October 2021 and October 2023, with 38% of transactions downgraded, due mainly to a reassessment of refinancing risks tiggered by higher interest-rate expectations and valuation adjustments reflecting business uncertainty.

Rating downgrades have subsided since October 2023, as retail generally reverted to pre-Covid activity and interest-rate expectations stabilised. That said, the sector remains exposed to evolving structural changes such as the rise of e-commerce and changes in consumer preferences, as reflected for instance in rising demand for luxury retail and the improved performance of shopping parks.

Office-backed transactions have faced challenges, although the downside rating pressure has recently abated, reflecting a reduction in operational uncertainties and a bottoming out in valuations. Between October 2020 and October 2024, 38.9% of transactions were downgraded, partly due to heightened refinancing risks but also because our coverage was affected by a significant share of assets under development. Meanwhile, 5.6% were upgraded due to transaction-specific factors, including improved metrics following portfolio upsizing. The office sector remains impaired by high vacancy rates stemming from pandemic-induced changes in working habits. Meanwhile, a strong market bifurcation has emerged, with higher demand for ESG-compliant quality properties while lower-tier office buildings face increasing vacancies and obsolescence risk.

4.3 2025 rating outlook

CRE transaction outlook mixed and sector specific

Our outlook on CRE transactions is mixed and sector specific. In this evolving environment, the bifurcation of the market will become further entrenched, with transactions that are prudently leveraged and secured against high-quality assets likely supporting stronger credit ratings. Conversely, transactions with lower debt yields and tight debt service capacity will continue to face significant refinancing risk despite the turn in the global rate cycle. As market dynamics change, the track record and capabilities of asset managers will be essential in ensuring sustainable cash flows, for instance through well thought-out letting strategies.

Easing inflation prompted gradual interest-rate reductions. Although this process has been slow, it has already tempered the trend of rising capitalisation rates for property assets. As a result, property values have stabilised and the appeal of commercial property as an investment option is slowly re-emerging. More liquidity from debt and equity investors will alleviate some refinancing pressures, but investors will be selective about the assets they choose to acquire or finance.

Regarding specific sectors, demand is still strong for logistics assets. However, given the still comparably tight investment yields, investors and lenders will need to pay attention to the acquisition price and valuation of property assets. Transaction with non-granular portfolios both in terms of properties and tenants are more prone to debt-service disruption because of the increase in bankruptcies observed throughout Europe and increased competition for prime assets. However, scarcity of good assets and the strong tail winds of e-commerce are positive for rental growth and ultimately valuation.

Beyond economic struggles, the key performance metrics in the residential sector (e.g. rental income growth, occupancy rates) reflect persistent demand-supply imbalances. While demand for housing remains high, supply is curtailed by a variety of factors, such as insufficient development funding, high construction costs, and the rising emphasis on environmental, social, and governance (ESG) standards, complicates development. Increased operating costs and concerns around rent affordability and potential rent caps are however reducing the net operating income and potential rental growth. Performance in retail, leisure and hospitality is highly transaction dependent. Strong properties managed by strong sponsors that can churn tenancies and keep vacancies low are likely to perform well. A track record of performance is essential for assessing debt-service capacities, highlighting the importance of management quality and operational stability in these sectors.

The bifurcation in the office market is expected to deepen, with prime properties in good locations likely to attract strong tenants and achieve strong valuations – even more so when assets have strong ESG standards. Sensibly geared loans with longer leases to strong tenants will be easily financeable. Meanwhile, loans secured on properties in secondary locations are unlikely to revert to pre-Covid occupancy levels, while obsolescence of some buildings coupled with high repurposing costs weight on net operating income and valuations.

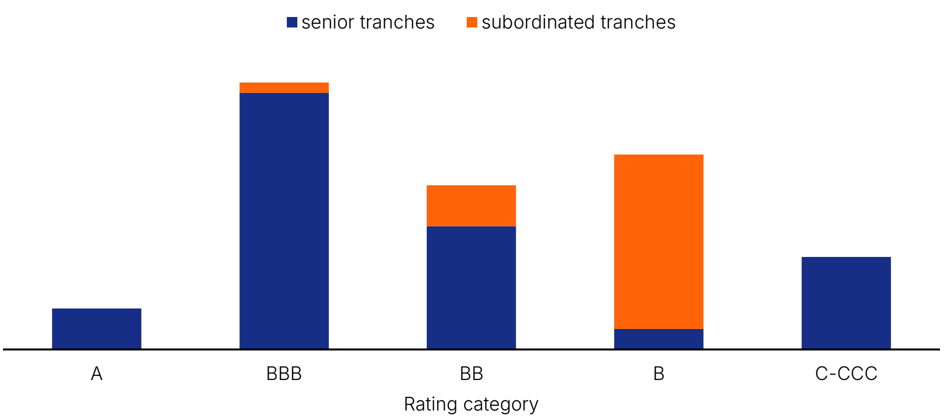
5. Non-performing loan (NPL) ABS

Most senior tranches rated IG at close; current rated universe dominated by sub-IG senior/mezz

Scope's NPL ABS-rated universe consists of transactions backed by mixed portfolios (i.e. portfolios which include both unsecured and secured exposures), non-performing leases, or portfolios composed solely of unsecured loans predominantly granted to individuals.

Most of our rated universe is in Italy but we also publicly rate transactions in Portugal (mixed and unsecured portfolios), Spain, Cyprus (mixed portfolios), Ireland (secured reperforming portfolios), and the UK (unsecured portfolios). Most senior rated tranches were rated low investment grade at closing, although the current rated universe is dominated by non-investment grade senior and mezzanine tranches, as the performance of secured portfolio segments has generally underperformed expectations, particularly in Italy.

Figure 14: NPL ABS rating distribution (October 2024)



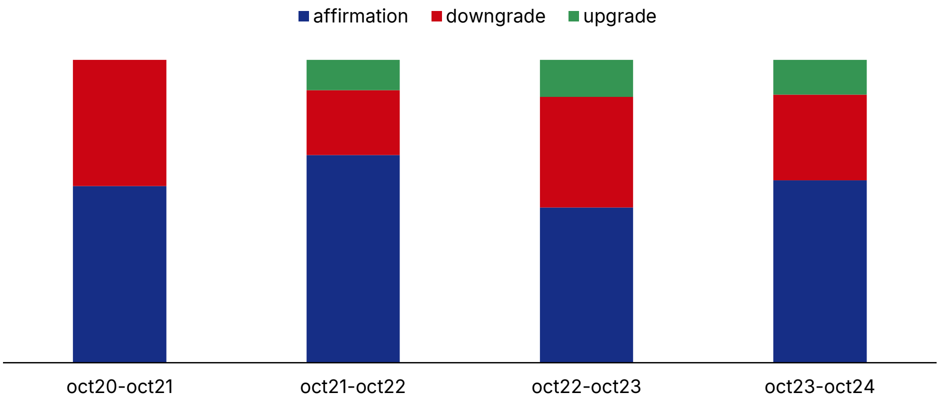
Source: Scope

5.1 Summary of monitored ratings activity

NPL ABS weakest asset class with strong negative ratings drift

NPL ABS was the weakest asset class for the October 2020 to October 2024 period, exhibiting strong negative ratings drift. Of the total number of annual reviews conducted on senior tranches, 33% and 10% resulted in rating downgrades and upgrades, respectively. Of the total number of periodic reviews conducted on subordinated tranches, 27% and 6% resulted in rating downgrades and upgrades, respectively. The rest of the periodic reviews – approximately 60% in aggregate – resulted in rating affirmations or no action.

Figure 15: NPL monitoring outcome



Source: Scope

5.2 Key monitoring factors

Negative ratings drift in NPL ABS driven by Italian transactions

NPL ABS performance has varied across jurisdictions. The overall negative ratings drift was driven by Italian NPL ABS predominantly backed by mixed NPL portfolios. The performance of mixed and secured portfolios in other jurisdictions has been balanced, while the performance of purely unsecured portfolios has generally been positive.

The underperformance of Italian NPLs was mainly observed in larger-than-expected discounts on collateral liquidations and in the limited profitability of extrajudicial strategies. We identify three key drivers behind this underperformance:

First, the quality of initial asset valuations was often below average and failed to fully capture the true condition of the underlying properties, leading to inflated expectations of recovery.

Second, the Italian legal framework does not allow securitisation issuers to directly repossess properties and sell them in the open market. Instead, the properties are sold through a lengthy and illiquid auction process which erodes asset values. For reference, observed discounts on Italian NPL collateral properties averaged 47.5%, while in other jurisdictions such as Spain and Portugal ranged from 5% to 15%.

Third, recourse to extrajudicial strategies to accelerate collections, particularly to note sales, has been at the cost of even higher valuation haircuts.

Compared to Italy, other jurisdictions such as Spain, Portugal and Cyprus benefit from legal frameworks that enable quicker resolutions through repossession processes, improving market liquidity. As a result, the performance of Portuguese and Cypriot transactions has generally met or even exceeded our expectations. Spanish transactions have shown mixed performance, in part limited by legal challenges related to foreclosure processes and issues related to squatting, leading to longer-than-expected resolution times.

By contrast to mixed and secured NPL portfolios, securitisations of reperforming loans or purely unsecured NPL portfolios experienced positive ratings drift in the 2020 to 2024 period, as recovery processes generally outpaced our baseline assumptions (see Unsecured NPL securitisations outperform transactions with mixed portfolios). The performance of reperforming or unsecured NPLs is primarily driven by two underlying drivers. First, performance is systemically driven by economic conditions, including labour market dynamics. These conditions have generally been supportive of borrowers' performance.

Second, the role of special servicers in managing complex and the highly granular underlying portfolios cannot be understated. In recent years, the unsecured special servicing market has matured, with experienced players increasingly leveraging technology to manage data and recovery processes.

5.3 2025 rating outlook

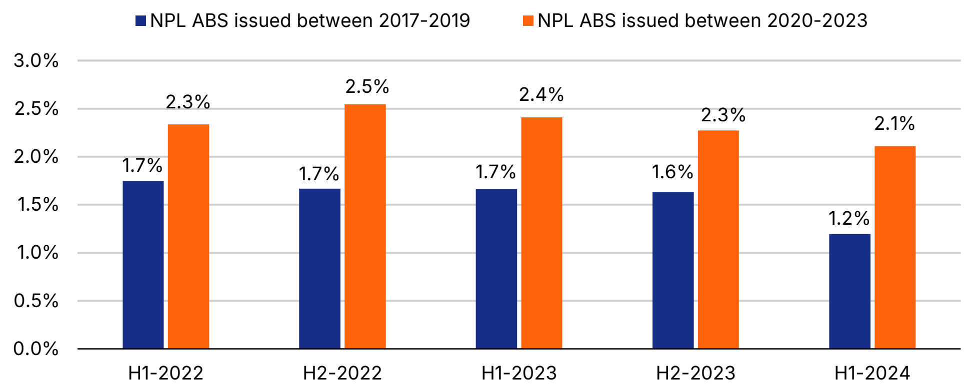
Neutral outlook on non-Italian and unsecured NPLs

Our outlook for non-Italian and unsecured NPLs is neutral, mainly driven by the current economic environment. However, this segment remains highly susceptible to potential risks, which could impact its stability and performance.

The balance of risks for Italian mixed NPL securitisations remains negative, although we see some gradual signs of rating stabilisation. We expect that collateral liquidation discounts will remain broadly stable, supported by a steady real estate market and an unchanged legal framework, but we believe that the more seasoned Italian transactions are unlikely to see significant reversals of their negative performance to-date.

Recovery rates are low, and the pace of collections is slowing (see Figure 16). Seasoned transactions are structurally weaker, with low thresholds for interest deferral triggers. As a result, in some cases, despite underperformance, issuer available funds are being diverted to the mezzanine notes. Additionally, due to slow deleveraging, these transactions are typically under-hedged, leaving them more vulnerable to interest-rate risk.

Figure 16: Italian NPLs average rate of collections



Source: Scope

In contrast to seasoned transactions, most recently originated transactions are generally performing in line with or above expectations and we expect them to maintain this trajectory in the medium term, barring the emergence of tail risks. Transactions that closed after the GACS renewal in 2019 are generally better positioned in terms of structural features and coverage ratios. Mezzanine interest deferral triggers and servicing fee deferral triggers have become more stringent.

Additionally, the proportion of senior notes relative to the gross book value has decreased since the pandemic, reflecting more conservative business plans. The share of senior notes as a percentage of the secured portfolio remained above 30% until 2020 but has gradually declined since, reaching an average of 15% in 2022.

Related research

Webinar: Trump 2.0 and the outlook for sovereign, bank and corporate credit, December 2024
Italian CQS ABS, November 2024
Supranational Outlook 2025, November 2024
Spanish banks 2025 outlook, November 2024
Italian Bank Quarterly, November 2024
Unsecured NPL securitisations outperform transactions with mixed portfolios, October 2024
EU banks NPL Heatmaps, October 2024
Global economic outlook, October 2024
European CRE/CMBS: decreasing refinancing hurdles, October 2024
French bank quarterly, September 2024
Structured Finance Activity Report: ratings drift shifts into positive territory, September 2024
Europe: narrowing the growth gap with the US by boosting resilience in Southern Europe, September 2024
The Draghi report: political stalemate and Europe´s productivity gap curb growth outlook, September 2024
European commercial real estate: credit outlook improves, August 2024

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