

Rating Action: Moody's downgrades EUR 170m CDO notes of Mare Baltic 2006-1

Global Credit Research - 21 Dec 2011

London, 21 December 2011 -- Moody's Investors Service announced today that it has downgraded the rating of the following notes issued by Mare Baltic 2006-1:

...EUR 170,011,000 Class A Floating Rate Limited Recourse Secured Asset Backed Notes due 2014 (currently EUR 24,668,869.38 outstanding), Downgraded to B3 (sf); previously on Mar 16, 2011 Downgraded to B1 (sf)

Mare Baltic 2006-1, issued in November 2006, is a static cash CDO backed by a highly non-granular portfolio of subordinated loans made to Danish commercial and savings banks. Six loans totaling DKK 975 million have been repaid upon the arrival of the five-year call option in November 2011, leaving eight loans with DKK 550 million exposure still outstanding. Class A has been redeemed by EUR 145 million or about 85% of the initial notional as a result of the repayment of the loans and the final payments from the swaps which matured in November 2011.

RATINGS RATIONALE

Today's rating downgrade reflects the credit deterioration in the underlying portfolio as well as the increased event risk associated with the very high concentration in the pool following amortisation.

The deterioration is reflected in the change in the weighted average credit quality of the pool from Ba3 to Caa1. The negative credit migration is due to widespread deterioration in the Danish banking sector and to the repayment of the better credit quality loans at the five-year call option date in November 2011. The six repaid loans had a weighted average credit quality of Ba3.

As a result of these repayments, the overcollateralization of Class A has increased substantially (from 132% at the last action to approximately 300% today). However, the underlying portfolio has become highly concentrated and there are only 8 loans remaining outstanding. In particular one loan represents nearly 40% of the total exposure, which makes the transaction extremely vulnerable to the performance of this particular loan.

This significant credit deterioration as well as the concentrated nature of the reduced portfolio has heightened the risk of Class A incurring a loss at the final maturity in November 2014.

Today's action also reflects the occurrence of two additional defaults in the portfolio since the last rating action in March 2011. Following the default of Fjordbank Mors in June 2011 and Max Bank in October 2011, the notional amount of Class B has been written down to DKK 376,106,930 from DKK 528,166,376 as reported in the last rating action in March 2011 (initial notional amount was DKK 879 million). Moody's is retaining the rating on Class B at Ca which is consistent with the Moody's expected recoveries for the notes, as outlined in the paper titled "Moody's Approach to Rating Structured Finance Securities in Default" (November 2009).

All the loans in the portfolio are assessed by credit estimates. In the base case scenario Moody's stressed the default probability of the pool by a factor of 30% in order to capture the increased rate of default. The stressed weighted average default probability of the pool was equivalent to a Caa3 rating in its base case.

Moody's also considered various additional scenarios, which include defaulting the largest exposure that had a two notch impact compared to the base case model output. Moody's also ran a positive sensitivity scenario, whereby it removed the default probability stress, which had a one notch positive impact on the base case model output.

The credit assessment of the portfolio reflects the difference in performance between senior and more junior debt since the beginning of the crisis, incorporating Moody's analytical framework on subordinated debts (see press release titled "Moody's Reviews Bank Hybrids, Subordinated Debt for Downgrade", 18 November 2009), whereby the Baseline Credit Assessments of the issuing banks have been notched down by two notches to account for the subordinated nature of the loans in the pool.

Because the portfolio references a low number of generally small Danish banks and concerns surrounding the Danish banking industry, Moody's believes the likely correlation in defaults between issuers in the pool is likely to be high. Correlation was assumed to be 50% for the base case, though a stress case of 75% was also looked at which had one notch negative impact compared to the base case output.

Recoveries on the subordinated loans in the event of default were assumed to be zero.

Moody's notes that this transaction is subject to a high level of macroeconomic uncertainty, which could negatively impact the ratings of the notes, as evidenced by uncertainties of credit conditions in the general economy.

As noted in Moody's comment 'Rising Severity of Euro Area Sovereign Crisis Threatens Credit Standing of All EU Sovereigns' (28 November 2011), the risk of sovereign defaults or the exit of countries from the Euro area is rising. As a result, Moody's could lower the maximum achievable rating for structured finance transactions with meaningful exposure to some of these countries.

Sources of additional performance uncertainties include:

- 1) Low portfolio granularity: the performance of the portfolio depends to a large extent on the credit conditions of a few large obligors that are rated low non investment grade.
- 2) Moody's believes the correlation in defaults between issuers in the pool will probably be high, with the consequence that remaining performance outcomes of the notes are likely to be binary in nature.
- 3) The entire portfolio consists of loans whose credit quality has been assessed through Moody's credit estimates. Further information regarding specific risks and stresses associated with credit estimates are available in the report titled "Updated Approach to the Usage of Credit Estimates in Rated Transactions" published in October 2009.

The methodologies used in this rating were "Moody's Approach to Rating Corporate Collateralized Synthetic Obligations" published in September 2009, and "Moody's Approach to Rating Collateralized Loan Obligations" published in June 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

In rating this transaction, Moody's used CDOROM to simulate the default for each assets in the portfolio. Losses on the portfolio derived from those scenarios have then been applied as an input in the cash flow model to determine the loss for each tranche. In each scenario, the corresponding loss for each class of notes is calculated given the incoming cash flows from the assets and the outgoing payments to third parties and noteholders. By repeating this process and averaging over the number of simulations, an estimate of the expected loss borne by the notes is derived. The Moody's CDOROM™ relies on a Monte Carlo simulation which takes the Moody's default probabilities as an input. Each portfolio is modelled individually with a standard multi-factor model reflecting Moody's asset correlation assumptions. The correlation structure implemented in CDOROM is based on a Gaussian copula.

As such, Moody's analysis encompasses the assessment of stressed scenarios.

In addition to the quantitative factors that are explicitly modelled, qualitative factors are part of the rating committee considerations. These qualitative factors include the structural protections in each transaction, the recent deal performance in the current market environment, the legal environment, specific documentation features, and the potential for selection bias in the portfolio. All information available to rating committees, including macroeconomic forecasts, input from other Moody's analytical groups, market factors, and judgments regarding the nature and severity of credit stress on the transactions, may influence the final rating decision.

REGULATORY DISCLOSURES

The rating has been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

Information sources used to prepare the rating are the following: parties involved in the ratings, parties not involved in the ratings, public information, and confidential and proprietary Moody's Investors Service information.

Moody's did not receive or take into account a third-party assessment on the due diligence performed regarding the underlying assets or financial instruments related to the monitoring of this transaction in the past six months.

Moody's considers the quality of information available on the rated entity, obligation or credit satisfactory for the purposes of issuing a rating.

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