SME Loan Securitisation 2.0

Market Assessment and Policy Options

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Abstract[1]

A well-functioning securitisation market is a way to ease the supply problems by helping banks diversify their funding and achieve capital relief. In October 2010 we presented our first working paper on SME loan securitisation (SMESec); since then the financial and economic crisis continued and the debate about the need to revitalise the SMESec market in order to support the real economy has grown further.

Despite the good performance of the European securitization market in general and the SME segment in particular in terms of low default rates the market environment for SME financing is still in a difficult shape, and the SMESec market did not recover – at least not the "real" primary market. Originators continue to mainly retain newly issued deals in order to create liquidity buffers and to use the assets as collateral with central banks; investors' confidence is not yet restored - and regulatory uncertainty is a major driver for concerns by originators and investors.

Recent initiatives and proposals concerning this market segment (e.g. by the European Central bank (ECB), the European Investment Bank (EIB) Group[2], and the European Commission) are aiming at the revival of the SMESec market, bearing in mind policy objectives. Its re-emergence would be an important element to enhance access to finance for SMEs in Europe.

This paper analyses the current state of the market for SMESec, its main framework conditions, and presents important developments and policy options.

[1] This paper benefited from comments by Frank Lang. All errors are of the authors.

[2] The EIB Group consists of EIB and EIF.

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1 Introduction

In October 2010 EIF presented a working paper on SME loan securitisation (SMESec). Since then, regularly twice per year, SMESec market updates are presented in the context of EIF's European Small Business Finance Outlook papers.[3]

Since the 2010-paper the financial and economic crisis continued, the market environment for SME financing is still in a difficult shape, and the SMESec market did not recover – at least not the "real" primary market. However, securitisation has a potential role to play in providing finance for "real economy" assets. This has been recognised by several studies highlighting 2 important issues:

- The degree to which banks can transfer their assets (market liquidity) is a fundamental driver for banks' asset allocation and lending decisions. In this respect SME loans are amongst the least liquid assets.
- The important role that "real-money" investors play in the financing of the economy, which is additional and complementary to the banking sector. However it should be noted here, that the proposed treatment of securitisation products from a capital perspective under the forthcoming regulatory frameworks (e.g. Basel III, Solvency II; see as well chapter 3.4) is rather punitive and will certainly further discourage long-term institutional investors from considering these assets for their investment portfolios.

A well-functioning securitisation market could be a way to ease the supply problems by helping banks diversify their funding and achieve capital relief. The OECD stated in 2011 (Blommestein et al., 2011) that "it seems likely that in the long run, structured-finance securitisation will once again become an important channel for debt markets; in the shorter term, securitisation may even rebound to support the global economic recovery, provided certain important pre-conditions are in place". However, as explained above, this development did not yet take place. SME securitisation placed with investors currently represents only a very small portion (approximately 1%) of total placed ABS issuance. The bulk of SME ABS is retained for ECB refinancing purposes and there is currently no real primary market.

Now, more and more often the important role of securitisation in financing and in particular SMESec is publicly voiced again. Against this background, this paper analyses the general situation of small business financing in Europe that also forms the framework conditions for SMESec; moreover, it investigates the SMESec market environment, as well as current initiatives and prospects.

The paper first briefly analyses the small business financing environment - in order to do that, the importance of debt financing is presented, followed by an analysis of the SME business and lending sentiment. In the next step, the SMESec market in Europe is analysed (chapter 3), before the multifaceted requests for public intervention to revive the market are presented and put into the context of justification of public and EU level support (chapter 4). In a next step, existing initiatives to revive the securitisation market are being presented (chapter 5). Finally, concluding remarks complete the assessment.

[3] See for the latest version: Kraemer-Eis et al. (2013a): http://www.eif.org/news_centre/publications/EIF_Working_Paper_2013_18.htm

2 Business environment and SMEs' access to finance[4]

2.1 Importance of debt financing

Debt financing is the most important source of external financing for SMEs. However, information on lending by enterprise size class is scarce, i.e. as regards actively borrowing enterprises there is no consistent data collection. Therefore, in order to get a clearer picture, EIF calculated an estimate based on available enterprise surveys and company statistics.[5]

According to the latest European Commission (2011) and ECB joint Survey on the Access to Finance of SMEs (SAFE)[6], in the EU27, 74.8% of all companies used debt financing (any source). Unsurprisingly, the use of debt financing increased with enterprise size class. Debt financing was used by 66.3% of all micro-enterprises, 79.3% of all small enterprises, and 85% of medium-sized enterprises (see table 1).

Table 1: Share of companies having used debt finance in the EU-27, by enterprise size class

		Total EU27	1-9 employees	10-49 employees	50-249 employees	SMEs (combined)	250+ employees
Used debt financing	%	67.4	66.3	79.3	85.0	67.4	88.4

Source: European Commission (2011), Wymenga et al. (2012), EIF RMA own calculations.

Multiplying the above-mentioned shares with latest information on the number of enterprises in each size class (see Wymenga et al., 2012) leads to an estimate of the number of companies by size class which have experience with debt finance. Table 2 shows the results of these calculations and underlines the importance of debt financing for SMEs.

Table 2: Number of enterprises having used debt finance in the EU-27, by enterprise size class

		Total EU27	1-9 employees	10-49 employees	50-249 employees	SMEs (combined)	250+ employees
Used debt financing	Number	13,999,855	12,692,154	1,076,524	192,587	13,961,265	38,590

Source: EIF RMA own calculations, based on European Commission (2011) and Wymenga et al. (2012).

According to the ECB's (2013b) latest Survey on the Access to Finance of SMEs in the Euro area (SAFE), access to finance remained the second most pressing problem for euro area SMEs. Moreover, it appears to be still a more severe concern for SMEs than for large firms. One potential reason for this structural weakness is that SMEs are more dependent on bank financing,

[4] Chapter 2 is based on Kraemer-Eis, Lang, Gvetadze, 2013a and 2013b. The first paragraph is based on an EIF-internal analysis performed by Frank Lang (2013).

[5] The European Commission (DG Enterprise) is aware of the poor availability of SME lending data and reflects on ideas how to improve the situation. EIF/RMA contributes to the discussion.

[6] The "Survey on the Access to Finance of SMEs in the euro area" (SAFE) is published every six months by the ECB. The more comprehensive survey to which reference is made here is conducted every two years in cooperation with the European Commission for all EU countries (and other countries).

such as loans and credit lines, than large firms (ECB, 2013c, and Cœuré, 2012)[7], since their access to alternative forms of (e.g. bond or equity) financing is limited (see for example Chava and Purnanandam, 2011, and Mosk and Ongena, forthcoming). Moreover, banks avoid supplying loans to SMEs due to the difficulties to securitise these loans. Hence, SMEs are more strongly affected by changes in bank lending due to deleveraging than other firms.

SMEs are a significant part of the total number of European firms and they strongly contribute to economic growth and employment. Recoveries heavily depend on countries' composition of firms and how those firms reacted on the recent credit crunch. Moreover, different from the US, it is more difficult for firms in Europe to substitute bank loans with debt securities. Since the most European countries strongly depend on bank loans, credit constraints can be particularly disruptive for European economic growth. Despite the existence of creditless recoveries (see Darvas, 2013 and Abiad et al., 2012) growth rates are higher in recoveries without imitations in credit growth. Therefore, European policy makers should try to revitalise impaired financial intermediation as this will likely stimulate economic activity and lead to higher growth.

2.2 SME business and lending sentiment

Despite the currently very weak business sentiment (see e.g. UEAPME, 2013), there are signs that "the economic downturn is set to bottom out" (Eurochambres, 2013), at least at a European average level. According to the European Commission's latest available forecast, the EU economy is expected to return to growth in the second half of 2013, and "growth should pick up at a moderate speed in 2014" (European Commission, 2013d). However, this outlook hinges on the critical assumption that another aggravation of the financial and sovereign-debt crisis can be prevented.

Due to the currently still difficult economic situation, European SMEs' demand for finance has decreased, and supply-side driven difficulties in access to finance have remained a reason for concern. The ECB Bank Lending Survey shows that, on balance, the reporting euro area banks have further tightened their credit standards to non-financial corporations; recently the overall net tightening has been applied more to SMEs than to large firms.

During the crisis, a combination of balance sheet concerns[8] on the banks' side, increased risk aversion and higher credit risks[9] in the SME business has caused reluctance to lend to SMEs.

[7] For the US, Berger and Udell (1998) found that "the vast majority of small businesses identify their commercial bank as their primary" financial institution, "presumably because banks provide the widest range of credit, deposit, and other related services". Moreover, "[t]he data also suggest that small firms tend to specialize their borrowing at a single financial institution".

[8] During the financial crisis, banks' balance sheets turned out to include unsustainable amounts of bad assets. The following necessary adjustment process involved (and still involves) "the recognition of legacy losses, the disposal of impaired assets, and the build-up of robust capital buffers supported by a reliable earnings capacity." This need to repair balance sheets has weighed on banks' ability to lend and has led to a "disruption to financial intermediation". And still, "[u]ncertainty about asset quality remains a greater concern in Europe" than in the US. See BIS (2013).

[9] See DZ Bank (2013). According to Kraemer-Eis et al. (2013a), "current economic developments will also lead to growing insolvencies". According to Euler Hermes (2013), insolvencies increased by 8% in the Euro area in 2011 and by 16% in 2012. Further increases are forecasted for 2013 (+21%) and for 2014

Additional liquidity, provided by the ECB via its Long-Term Refinancing Operations (LTROs) was only partially used to finance SMEs (i.e. in peripheral countries), but instead used to buy government bonds in order to benefit from high spreads and low capital requirements. Given these circumstances, in many countries – from a risk/return perspective – lending to SMEs is only attractive for banks if they charge high interest rates, also against the background that authorities are already considering increasing (Basel III-) capital requirements (DZ Bank, 2013). During the crisis, European banks started the deleveraging process due to new capital regulations and funding constraints (see box 1).

Box 1: Banks' deleveraging – a recent analysis of the situation in Europe

This box is based on Mosk and Ongena (2013). The paper investigates the deleveraging process of the European banking sector since the onset of the financial crisis in 2007 and its impact on corporate investment.

It shows that, while many European governments recapitalised the banks in their countries and provided guarantees, banks are still highly levered in some countries (e.g. Austria, Denmark, Germany, UK), face funding constraints and are still highly dependent on ECB funding (e.g. Belgium, France, Germany, Italy) and face increasing non-performing loans (e.g. Bulgaria, Greece, Hungary, Italy, Latvia, Romania, Spain). According to the analysis, the deleveraging process resulted so far in a reduction in the provision of credit, although the correlation between bank leveraging and lending activity was found stronger in Southern than in Eastern Europe.

The on-going crisis remains a risk for all European countries, and it could directly or indirectly result in rapid contraction in bank lending because of acute funding and capital shortages. Moreover, the paper finds that the investment of small, non-listed firms is strongly correlated with banking sector leverage.

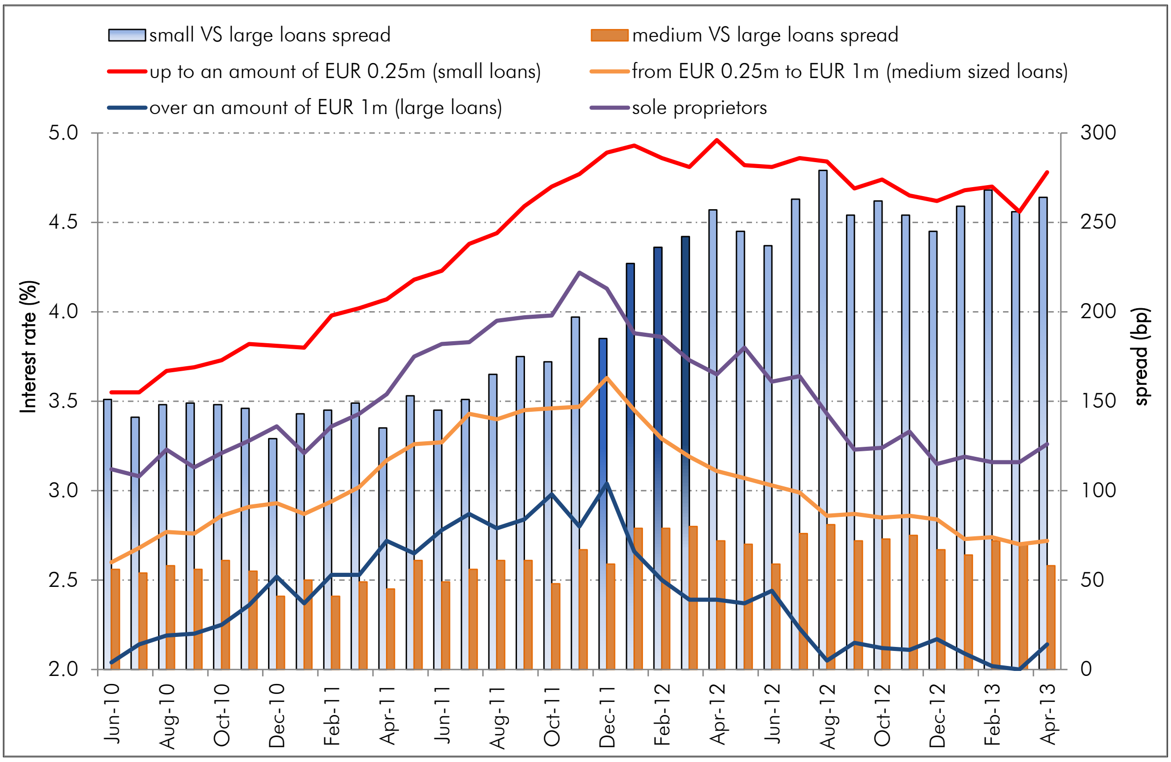
A survey by Deloitte (2012) showed that two thirds of the surveyed banks expect the process of deleveraging to last at least five more years. The Mosk/Ongena paper finds that the pressure on banks in Europe will most likely be higher for smaller banks with business models focused on lending to domestic households and SMEs and that banks in Southern European countries are likely to reduce their leverage in the coming years. Hence, especially for these countries there is a risk that deleveraging leads to a credit-crunch.

As policy recommendation, inter alia, the paper proposes SME loan securitisation programs to reduce funding constraints, possibly combined with guarantee schemes in order to address the structural issues of SME lending (driven by asymmetric information and moral hazard – and which are more severe during recessions).

(+7%). As SME insolvency rates are not publicly available, one has to assume that general developments in insolvencies also apply for SME insolvencies. However, for those countries in which the manufacturing sector currently accounts for relatively high shares in total insolvencies (e.g. Portugal, Italy, and Spain), Creditreform (2013) notes that "the firms going broke tend not to be industrial companies but small-scale craft businesses". Moreover, in parallel to increased credit risks, European banks' risk aversion has increased during the financial crisis (see EBA, 2012; for an example see Düwel et al., 2011).

The ECB MFI (Monetary Financial Institution) Interest Rate Statistics also indicate more difficult credit conditions for SMEs. The data reveal that the interest rate spread between small loans (up to an amount of EUR 0.25m) and large loans (more than EUR 1m) has shown an increasing trend from an average level of 145bp before July 2011 to a record high of 279bp in August 2012; since then, the spread has been rather stable at an average level of 258bp (see figure 1).

Figure 1: Evolution of monetary financial institutions interest rates on new loans to non-financial corporations[10]



Sources: Based on Huerga et al. (2012), ECB (2013a) and own calculations

Using small loans as a proxy for the financing cost of SMEs (Huerga et al., 2012), this elevated divergence "may point to some degree of discrimination by banks against small firms" (ECB, 2012), in particular in the countries most affected by the deepened sovereign debt crisis. The relatively difficult access to finance conditions for SMEs in those countries is particularly worrying, as SMEs account for important shares of gross value added in these countries.[11]

[10] New loans to non-financial corporations with floating rate and up to three-month initial rate fixation by loan size and new loans to sole proprietors (percentages per annum excluding charges; period averages). The series about new loans to "sole proprietors" have an initial rate fixation period of up to one year and not up to three-months as the rest of the series used in the graph because data for lower periods of fixations are not collected.

[11] The results found by Jiménez et al. (2012) point into the same direction. Based on a dataset for Spain, which contains monthly information requests by banks following loan applications from firms, they separate loan supply from demand, and find that "higher short-term interest rates […] reduce loan granting" and that this effect is stronger for banks with low capital or liquidity. Hence, their findings "suggest that, under tighter monetary and economic conditions, a reduction in bank capital begets a credit crunch."

The differences in lending conditions are also indicative of a more fundamental fragmentation of the EU's financial market, as lending spreads relate not only to the credit quality of the borrower but also to the geographical location, thus resulting in a fragmentation of financial markets.

According to the ECB executive board member Benoît Cœuré, "such credit tightening currently appears to be very severe for SMEs […] because SMEs are often unable to switch from bank credit to other sources of external finance. […] Difficulties in borrowing, which influence not only their day-to-day activities, but also their ability to grow, may then easily transform liquidity constraints into solvency risk." As the substitution of bank loans by trade credit, leasing or factoring is "strictly related to the business activity of companies and in recessions their buffer role might be limited by the reduction in the exchange of goods and services" (Cœuré, 2013), additional public policy support measures, such as guarantees or investments in venture capital, which help to alleviate SMEs' collateral and equity shortages might prove valuable to improve SMEs' access to finance and to reduce the cost of financing.

Moreover, with regard to the credit channel of monetary policy, an IMF Working Paper concludes that this channel has broken down during the crisis, i.e. in stressed economies, and that in these countries SMEs have been most affected by elevated lending rates (Al-Eyd and Berkmen, 2013). In general, the relatively difficult access to finance conditions for SMEs in those countries which are suffering the most from the sovereign debt crisis is particularly worrying, as SMEs account for relatively large shares of gross value added in these countries, as was pointed out in a recent Morgan Stanley Research (2013) paper. The study concludes that it is in particular the "highly SME-dependent economies that face the greatest challenges – or an SME squeeze".

The pressure on European banks to deleverage continues (see e.g. above box 1), and banks have to raise fresh capital or to reduce their balance sheets, based on existing and/or increasing credit risk and also in order to anticipate and fulfil future Basel III rules. One possible reaction is to downsize lending activities; another direction could be to use SMESec as tool: a recovery of the primary securitisation markets could play a role in unlocking credit supply and economic recovery – via both ways, true sale and synthetic transactions. However, this will only be to the benefit of SMEs if the freed-up capital / fresh liquidity is going to be used to finance the real economy (i.e. for new SME lending) and not for e.g. regulatory arbitrage.

In this sense, a SUERF study (Jackson, 2012) concluded: that "… urgency should be placed on the development of a new securitisation market, with new instruments, containing features making them less risky and more transparent – limited tranching, standard prospectuses, a summary of risk factors, transparency on risk in the pools, loans going through bank lending standards, cross market default data and clear disclosure. (…) The advantage of an active and high quality securitisation market is that it would enable banks to deleverage to meet the higher capital requirements without damaging lending to sectors which cannot themselves tap the securities markets."

In fact, now, more and more often the important role of securitisation in financing and in particular SMESec is publicly voiced again, inter alia by the European Commission (e.g. European Commission, 2013a; European Commission, 2013b) or the Group of Thirty (The Group of Thirty, 2013). Also the ECB has repeatedly stressed the importance of SMESec and also raises the point to reconsider the appropriateness of regulatory capital requirements for ABS in order to revitalize SME funding (see Cœuré, 2013). ECB Board Member Jörg Assmussen, speaking about supporting ABS markets, said on the 08th May 2013: "[We] have an open mind to look at all things we can do within our mandate, and this relates to how can the market for asset-backed securities, especially backed by SME loans, be revived in Europe, of course under strict supervision."

In its Monthly Bulletin, the ECB (ECB, 2013e) states that it is generally recognised that well-regulated, high-quality and transparent securitised products can play an important role in capital markets. These products can satisfy investor demand for secured, highly rated, and liquid debt instruments, and can provide maturity-matched funding for a bank's assets. In addition, the structured nature of ABSs can attract a variety of market participants and help to transfer risks across the financial system, provided these are sufficiently understood (i.e. structures and pricing), which in turn can help to build resilience against unexpected market shocks. More broadly, ABSs can also stimulate real economy funding, including SME financing. An efficient and liquid ABS market would also be welcome from a central bank perspective: ABSs' role in "liquefying" difficult-to-sell assets provides an important collateral asset class. This can be crucial in times of crisis for ensuring that sufficient liquidity is provided to counterparties while adequately safeguarding the central bank balance sheet. The difficult issuing environment may also have had an impact on new loan origination, particularly among SMEs in certain weak economies, a challenge recently highlighted in the European Commission's Green Paper on the long-term financing of the European economy (ECB, 2013e; European Commission, 2013 a/b).

In this context, the ECB Governing Council decided to start consultations with other European institutions on initiatives to promote a functioning market for asset-backed securities collateralised by loans to non-financial corporations" (Draghi and Constâncio, 2013). In particular, initiatives are currently being pursued, with potential additional support by the EU budget.

Also the three pan European regulators European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) stated recently jointly that "given the deleveraging of the EU banking sector, market expectations for future changes in the current low interest rate environment and a general need for an increased availability of funding to the real economy, a thoroughly risk-managed and transparent securitisation has the potential to step in as an alternative for financial intermediation" (ESMA/EBA/EIOPA, 2013).

Against the background of these framework conditions and i.e. the difficult situation concerning access to finance for SMEs, the following chapters analyse the market for SME loan securitisation in Europe, as well as potential developments.

3 Assessment of the European securitisation market[12]

Banks do not lend to SMEs based on macroeconomic development motives (e.g. supporting the economy), but they make a complex calculation of the profitability of their SME business, especially relative to their other activities. In these calculations there are multiple parameters such as origination, credit assessment and servicing costs (Kraemer-Eis et al., 2010). The degree to which banks can transfer their assets (i.e. the degree of (current and expected future) market liquidity) is a fundamental driver for banks' asset allocations and lending decisions. In this respect SME loans are amongst the least liquid assets. SME loan securitisation (SMESec)[13] can help to improve this situation.

SMESec creates indirectly a "secondary market for SME loans", combined with funding for the originator and possibly capital relief: a bank (the "originator") bundles loans extended to its SME customers in a pool and sells the portfolio to capital market investors through the issuance of notes by a special purpose vehicle, backed by such a loan portfolio (Asset Backed Securities). As an alternative to this true sale of the portfolio there is the so called "synthetic securitisation" where traditional securitisation techniques are combined with credit derivatives in order to provide credit protection on a pool of loans. In this case the credit risk of a selected reference portfolio of loans (but not the loans themselves, which remain on the balance sheet of the originator) is transferred to the capital market through the issuance of notes (Credit Linked Notes), classified by risk categories(Kraemer-Eis et al., 2010).

There are many advantages of SMESec – for banks, for investors, for the economy, and – most importantly - for the SMEs (see for a detailed discussion Kraemer-Eis et al., 2010, i.e. pp. 8ff.). At first sight, the advantages are mainly for banks and investors, but these benefits can channel through to a positive effect on SME's access to finance and hence to the SMEs themselves (see e.g. Ranné, 2005), especially in cases where the participation in the transaction of public institutions is linked to a commitment by the originator to extend new loans to SMEs.

3.1 Overall securitisation activity

The European securitisation market had grown steadily from the beginning of the decade until the outbreak of the crisis. Prior to the crisis, European issuance was often driven by funding needs (Blommestein et al., 2011). During the crisis, issuance remained at high levels, but these volumes were almost exclusively driven by the eligibility of Asset Backed Securities (ABS) as collateral for ECB liquidity operations. After having peaked in 2008, in 2009 and 2010 the overall market activity decreased to the levels just before the crisis due to regulatory uncertainties and tighter Euro system collateral rules.[14] Rating downgrades, based on negative credit trends and revised rating agency criteria (without grandfathering), contributed to the negative market sentiment.

[12]If not flagged otherwise, the data source is AFME, the Association for Financial Markets in Europe.

[13]The term SME Securitisation (SMESec) comprises transactions based on SME loans, leases, etc. The reader can find a securitisation glossary in Annex 1.

[14]The ECB's asset repurchase or "repo" facility allows (among other assets) Asset Backed Securities to be used as collateral for funding.

However, despite the crisis, the European securitisation market in general performed relatively well with comparably low default rates.[15]

Nevertheless, SMESec, as important element of the financing of SMEs in Europe, is still suffering from the economic and financial crisis. The near-collapse of the European structured finance market, in tandem with the other markets around the globe more generally, has profoundly affected the status and outlook of SMESec. Unfortunately the situation has only slightly improved over the recent past. It is still the case that originators mainly retained newly issued deals in order to create liquidity buffers and to use the assets as collateral with central banks for re-financing purposes. At this point in time we can still not talk about a functioning primary market.[16]

As a consequence, overall securitisation activity was high during the crisis (but this mainly reflects retained transactions), with a peak in 2008 (EUR 711bn) and since then a continuous decrease. The *issuance* in Europe went down significantly (-33%), from EUR 372bn in 2011 to EUR 251bn in 2012 (for comparison: a level like in 2004). Q1/2013 was in terms of overall issuance the weakest since 2002.

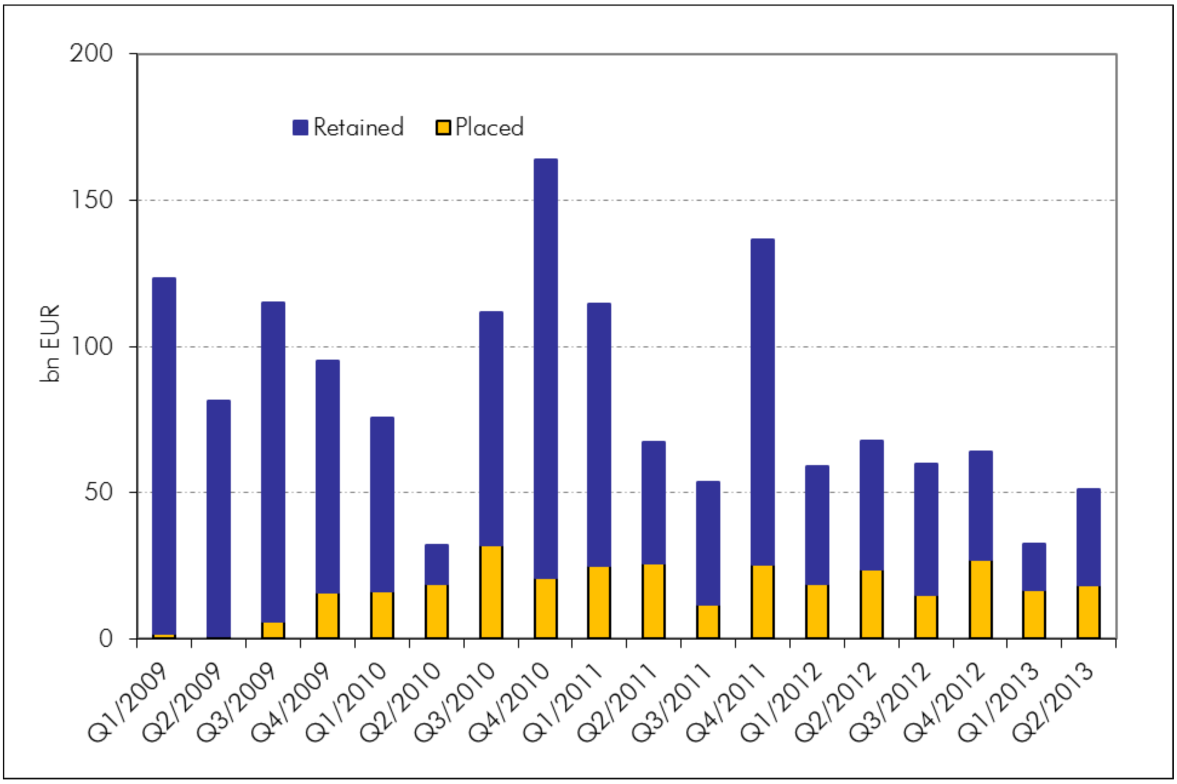
The most active markets in terms of issuance were the UK (market share in 2012: 30%), Italy (23%) and the Netherlands (19%). The overall reduction in collateral production is mainly based on a reduced issuance of UK Prime Residential Mortgage Backed Securities (RMBS); reason for this development in the UK is the availability of the "Funding for Lending Scheme", FLS (since August 2012) that provides potential UK RMBS originators with cheaper refinancing via the Bank of England (DZ Bank, 2013). FLS aims at reducing the costs of banks' funding in exchange for commitments to lend more (to mortgagors and companies); originally it was foreseen to stop the scheme in January 2014 but recently the Bank of England and HM Treasury announced an extension until end of January 2015. The scheme will now also be extended to non-bank lenders like financial leasing, factoring and mortgage and housing credit corporations, which were originally excluded from the scheme. Moreover, SME lending is further incentivised, with a higher multiple being included for SME lending (UniCredit, 2013a). It can be expected that the FLS will keep the UK securitisation issuance on lower levels.

For the full year 2012, the retention (see figure 2) was at around 66% (2011: 76%) and in HY1/2013 it went down to 58%. At first sight, the reduced retention rates look encouraging, but this is only in relative terms as the overall issued amounts went down (see also figure 3) and the amounts placed with investors went down by 4% (2011: EUR 88.3bn, 2012: EUR 84.8bn).

[15]Please note that, due to structural protections available to transactions, weakening portfolio performance does not necessarily result in downgrades or even defaults of ABS notes placed with investors.

[16]For information, in July 2013, the ECB relaxed its collateral eligibility rules to reduce haircuts applicable to ABS in order to catalyse recent initiatives by European institutions to improve funding conditions for small and medium-sized enterprises.

Figure 2: European total securitisation issuance by retention (bn EUR)



Source: Based on data from AFME (2013a/b/f)

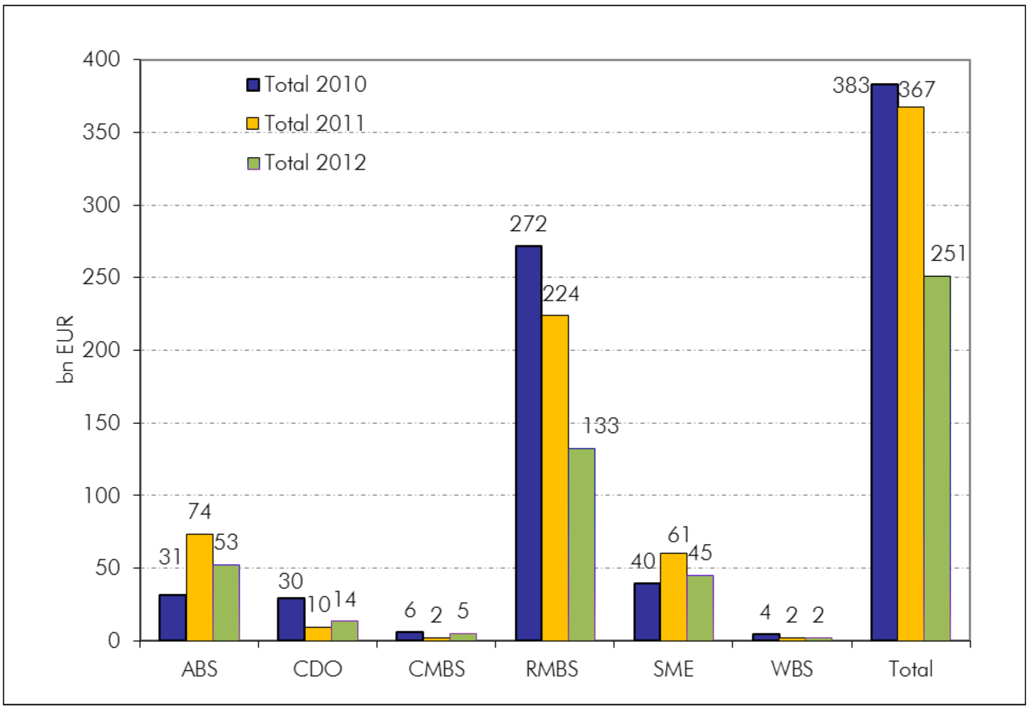
3.2 SMESec activity

Given the dominance of the securitisation of RMBS, SMESec remained a relatively limited but important segment of the European structured finance market (see figure 3).

The market share of SMESec rose (with some volatility) from 6% in 2001 to 18% (of total yearly issuance) in 2012, the highest value ever registered in Europe – but this came due to the base effect, as the overall activity went down (see figure 4). The issued volume of SME deals in HY1/2013 was similar to the same period a year before (EUR 13.6bn compared to EUR 13.9bn in HY1/2012). However, as already mentioned, it is important to note that only a very small fraction of the issuance has been placed with investors: The nature of the SMESec market changed from a developing market (pre-crisis, with almost all transactions placed on the primary market) to a purely ECB repo-driven market during the crisis (with almost no placement on the primary market). The main issuance activity in HY1/2013 was in Italy (46%), Spain (43%), and Portugal (8%).

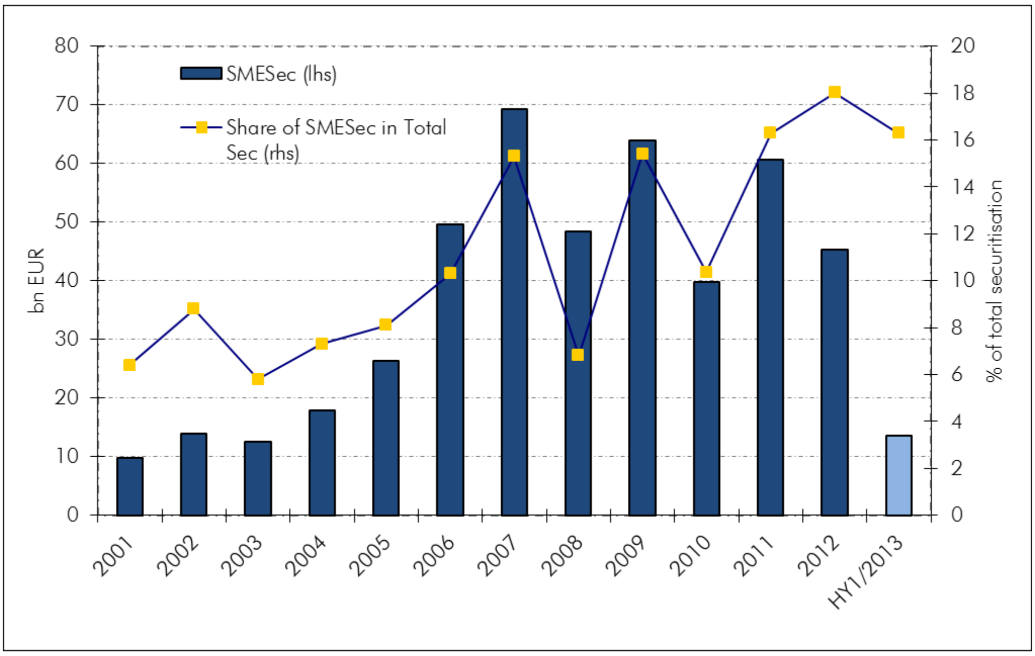
According to an analysis by DZ Bank (DZ Bank, 2013), the main investors in publicly placed European securitisations were funds (49%) and banks (39%) from the UK (40%), France (12%), and Germany (12%).

Figure 3: European securitisation issuance by collateral (bn EUR)[17]



Source: Based on data from AFME (2013a)

Figure 4: SMESec transaction volumes in Europe and share of SMESec in total securitisation

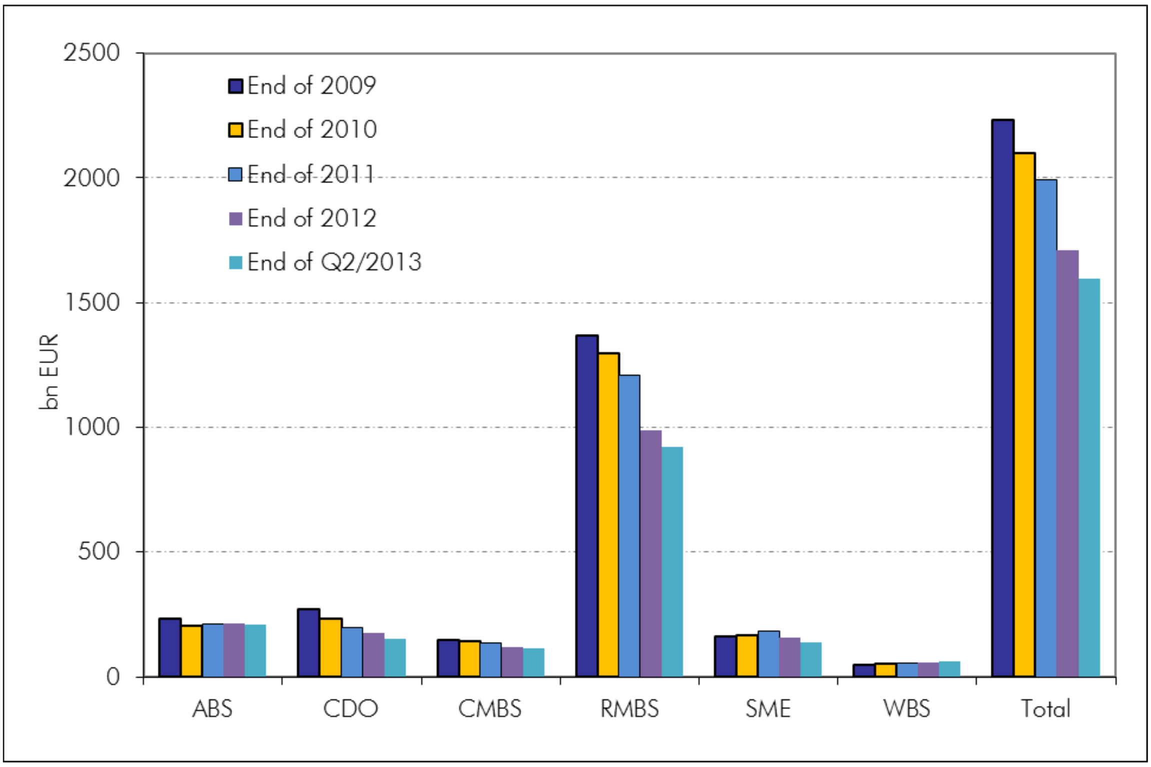


Source: Own calculation, based on data from AFME and KfW

[17]AFME definitions: European ABS issuance includes auto, credit card, leases, loans, receivables and other. European CDO issuance numbers only include issuance denominated in a European currency regardless of the country of collateral. A substantial percentage of CDOs are backed by multi-jurisdictional collateral. Historical CDO issuance totals have been revised due to periodic updates of the sector. WBS: whole business securitisation – a securitisation in which the cash-flows derive from the whole operating revenues generated by an entire business or segmented part of a larger business.

With regard to the *outstanding securitisation transactions*, compared to end of 2011, the total outstanding decreased by 15% from EUR 1,992bn to EUR 1,595bn (end of Q2/2013, see figure 5). The regional distribution of the outstanding is similar to the distribution of the total issuance and remained almost unchanged to the past: in terms of volumes UK ranks first (28.8% of the EUR 1.595bn), followed by the Netherlands (17.5%), Italy (11.9%) and Spain (11.6%).

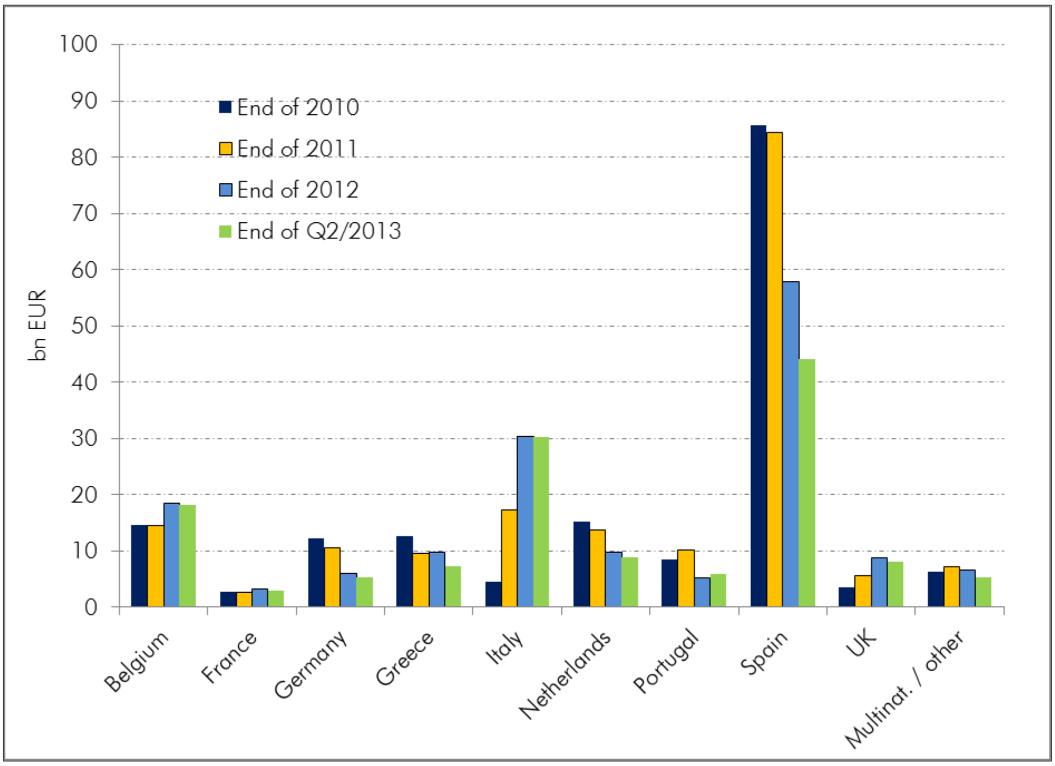
Figure 5: European outstanding securitisation transactions (by collateral, bn EUR)



Source: Based on data from AFME (2013a)

Referring to SMESec, since end of 2011, outstanding volumes decreased by about almost 15% (from EUR 181bn to 158bn (end of 2012), to EUR 154bn, end of Q1/2013). If the EUR 158bn of outstanding SMESec are broken down by country (end of 2012), the significance of the Spanish market becomes obvious, although the outstanding volumes decreased significantly over the past years (see figure 6).

Figure 6: European SMESec outstanding volume by country (bn EUR)



Source: Based on data from AFME (2013a)

3.3 SMESec performance trends

Despite the financial and sovereign crisis, the European securitisation market in general performed so far relatively well in terms of losses.[18] The low losses are not only based on the typically high granularity/diversification of these transactions, but also on structural features that helped to counterbalance negative effects of the deteriorating European economy (i.e. increased SME default rates).

As shown above, the track record of SMESec in Europe is relatively short; the market started only towards the end of the 1990's – at the time, this segment was unknown to investors and rating agencies, and the technique of securitisation was also new to most of the originators. The related uncertainty was one of the reasons for in general conservative structures in the general SMESec segment.[19]

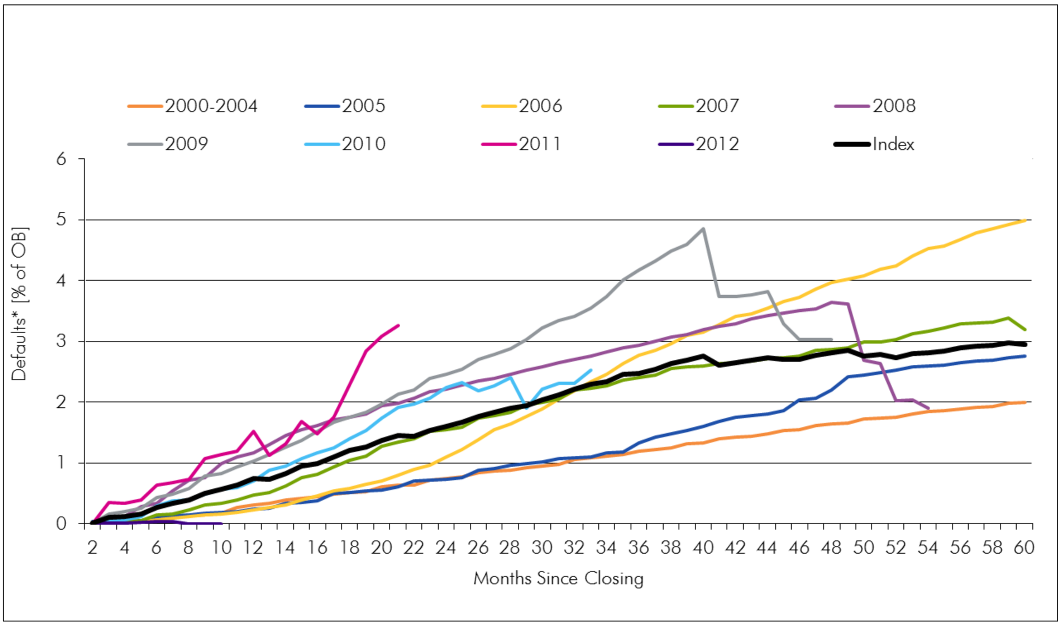
[18] 2012-data shows that, according to the rating agency Standard & Poor's, the European structured finance default rate since beginning of the crisis (mid-2007) is low: only 1.1% of European structured finance securities outstanding in mid-2007 have defaulted; this default rate is well below the one of US pendants (14.8%). For the SME segment, the rating agency registered defaults (weighted by notional value at issuance rather than by number of tranches) of 0.23% (Standard & Poor's, 2012); such defaults refer to junior notes of Spanish securitisation transactions.

[19] In the years running up to the crisis there were first signs also in Europe of a drift away from key principles and main success factors for SMESec – i.e. granular portfolios and transparent structures – for example in the form of hybrid transactions (i.e. the so-called German Mezzanine CDOs) with non-granular portfolios, larger (mid-cap) borrowers and non-aligned incentive structures. The generally poor performance of these transactions provides lessons for the future of SMESec.

The tightening of credit conditions for SMEs has been mentioned earlier; although this development has a direct negative impact on the SMEs it has indirectly a positive effect for new loan vintages, and hence the quality of newly securitised portfolios, as banks have become more risk averse. However, the sovereign crisis and weak macroeconomic fundamentals in many European countries had also negative effects on SME transactions and it is expected that the credit quality of existing portfolios in stressed markets will further deteriorate – the credit performance of SME portfolios is typically dependent on GDP growth trends. Moreover, many counterparties in SME related transactions will continue to suffer from the on-going stress in the European banking system.[20] In fact, latest data shows that the performance of SME ABS deteriorated. For example, in the SMESec transactions rated by Moody's (in the EMEA[21] region), the 90-360 day delinquency rate rose to 4.91% in December 2012 from 2.13% in December 2011, predominantly reflecting the weakness in markets such as Portugal, Spain, and Italy. However, a small number of badly performing transactions are mainly responsible for the weakness in these markets (Moody's, 2013b).

Figure 7 depicts cumulative credit events (or defaults) on original balance by vintage for the EMEA region (transactions analysed by Moody's). It shows a relatively constant development over time for most vintage years.

Figure 7: EMEA SME ABS cumulative credit events or defaults on original balance (seasoning by vintage)[22]



Source: Moody's (2013a)

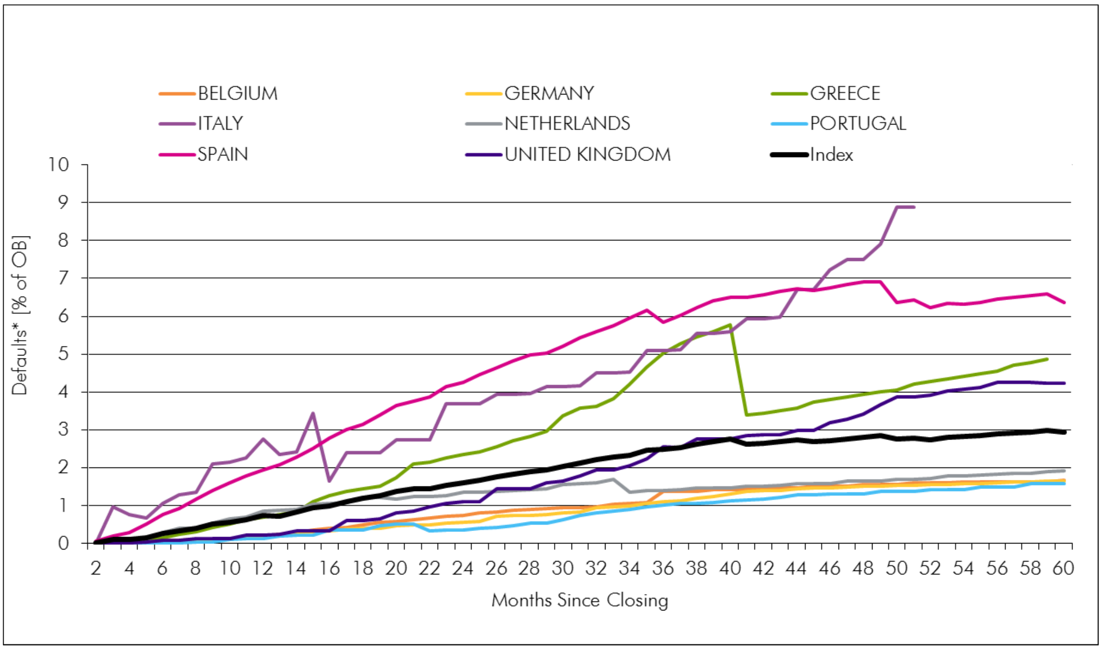
[20]We discussed the impacts of the sovereign crisis on securitisation transactions in more detail in our ESBFO in December 2012: http://www.eif.org/news_centre/publications/eif_wp_2011_12.pdf.

[21]The "EMEA region" includes Europe, Middle East, and Africa; with regard to Structured Finance most of the transactions in this region are in Europe.

[22]Terminated transactions are included in the index calculation; Moody's believes that this information must be included for an accurate representation of trends over time. Additionally, Moody's notes that vintage seasoning charts might move unexpectedly for the last few data points because transactions start at different points in time within a vintage and hence some transactions may be more seasoned than others. The index includes only the transaction rated by Moody's.

However, the performance differs from country to country (see figure 8). Moody's e.g. reports that the recent performance of EMEA SME ABS transactions showed weak trends in Greece and Italy and stable trends in most of the other jurisdictions.

Figure 8: EMEA SME ABS cumulative credit events or defaults on original balance (seasoning by country)



Source: Moody's (2013a)

Due to various reasons and as explained in more detail in several EIF working papers (e.g. Kelly and Kraemer-Eis, 2011), also the SMESec market has been hit by a wave of downgrades due to weaker performance as well as rating methodology changes. Typically, AAA tranches show strong rating stability, but today also AAA and AA tranches migrate downward, mostly driven by downgrades of the respective country/sovereign ratings and the limitation by the country ceilings (Fitch, 2013b), or driven by downgrades of (not replaced) counterparties (whose rating is also affected by the respective sovereign ratings).

The rating transition data shows that the downgrade pressure for SME transactions was across all tranche levels. The following example (table 3) shows the tranche rating migration since transaction closing of the SME Collateralized Loan Obligation (CLO) transactions that have been rated by Fitch. For example: of all tranches that have initially been rated AAA, 31% (by number) have paid in full (pif), only 12% are still AAA, 23% moved down to AA etc. Meanwhile, there has been very limited upgrading, and no tranche was upgraded to AAA.

Table 3: Fitch European SMEs Rating Transition Matrix (April 2013) [23]

% of tranches		Current rating									
		PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf
Initial Ratings	AAAsf	31%	12%	23%	21%	9%	3%	0%	1%	0%	0%
	AAsf	15%	0%	29%	12%	12%	9%	15%	6%	3%	0%
	Asf	6%	0%	10%	44%	10%	10%	13%	2%	2%	2%
	BBBsf	6%	0%	0%	6%	6%	27%	10%	25%	14%	6%
	BBsf	4%	0%	0%	0%	8%	19%	19%	15%	23%	12%
	Bsf	0%	0%	0%	0%	0%	57%	14%	0%	0%	29%
	CCCsf	0%	0%	0%	0%	0%	0%	0%	10%	30%	60%
	CCsf	0%	0%	0%	0%	0%	0%	0%	0%	40%	60%
	Csf	0%	0%	0%	0%	0%	0%	0%	0%	0%	100%

Source: Fitch (2013c)

3.4 A changing regulatory environment

There are many regulatory and policy initiatives underway that are going to affect the securitisation markets (i.e. concerning capital requirements, liquidity, governance, due diligence, leverage requirements) with the objective to correct the deficiencies of the pre-crisis time.[24] Against the background of regional differences (that also lead to differences in the performance, e.g. US versus European ABS) and a variety of products on the one hand, and the need to ensure risk sensitivity and to avoid complexity on the other hand, the design of effective regulation at global and EU level is a difficult task (ECB, 2013e).

However, the recovery of the European Structured Finance market will not only depend on the development of market fundamentals and the enhancement of investors' confidence but also strongly on the direct and indirect impact from regulatory priorities. Hence, future/potential regulatory treatments of SMESec have to be duly analysed; for both, investors and originators, a stable and reliable regulatory framework is key. Moreover, a holistic view should be taken as the regulations are developed (Frohn, 2013). Most individual proposed regulations make sense on a stand-alone basis, but some might also be questionable, taking into consideration the overall picture of the regulatory wave.

On the product side, as an example, a level playing field is required between different bank funding instruments (in particular, securitisation and covered bonds). Covered bonds are perceived to be less risky than ABS because the investor has a double recourse provision, i.e. to the issuer and to the underlying asset portfolio. Covered bonds are typically more economical for larger financial institutions, given the burden required for the management of these instruments

[23] The addition sf indicates a rating for structured finance transactions.

[24] Based on the current Basel 3 framework, banks' capital against securitisations will have to increase significantly. Bank of America/Merrill Lynch estimates that European banks must increase their capital against securitisation bond holdings by (depending on the approach used) EUR 23bn to EUR 47bn (Bank of America/Merrill Lynch, 2013).

and the higher rating support provided by the issuer, and are characterised by a lower protection from the underlying portfolio (i.e. lower credit enhancement and less stringent asset eligibility criteria) compared to high quality ABS senior tranches (however, there is now the tendency that even smaller financial institutions set-up covered bond programmes). Furthermore, covered bonds are sometimes seen as a potential threat to other unsecured investors, given the special treatment provided for by law and there is a growing need to set encumbrance limits at an appropriate level.

Also the ECB (ECB, 2013e) states that capital charges must be set sufficiently high to ensure that banks and other regulated investors set aside sufficient funds as risk buffer. However, the specific performance and features of European ABSs have to be taken into account, otherwise these capital charges could unfavourably skew risk-adjusted returns on capital. In case of the latter, investors (i.e. banks, insurers, and pension funds), may demand higher yields - which may result in the issuance becoming uneconomical from the originator's perspective. Alternatively, these investors may also decide to exit the market (due to insufficient risk-adjusted returns on capital, also in view of the high costs of maintaining specialised teams with structured finance skills for a shrinking investment activity.

As an exhaustive and detailed discussion of forthcoming or planned regulatory adjustments is not possible here, an overview (provided by AFME) is shown in Annex 3. Moreover, e.g., Frohn (2013) provides a preliminary analysis of changes in post crisis securitisation regulation.

4 The call for public intervention

4.1 Requests to intervene

As mentioned above, now, frequently the important role of securitisation in financing and in particular SMESec is publicly voiced again. Contemporaneously, there are calls for public intervention in order to revive the SMESec market.

The ECB (Cœuré, 2013) recently stated that supranational support measures to SMEs "could be enhanced" such as "traditional instruments […] related to the European Investment Bank (EIB) lending to SMEs and the European Investment Fund's (EIF) actions in the ABS market designed to revive investors' interest and confidence, by facilitating large and liquid transactions" (Cœuré, 2013). In addition, improvements in regulatory framework conditions can facilitate SMEs' access to finance, as well as current initiatives to revive SME securitisation. ECB executive board member Peter Praet (2013) recently stated that "a reopening of the ABS market may be one way of enhancing funding conditions for SMEs".

The IMF (2013) encourages European policymakers to further the restoration of private securitisation channels. This includes a realistic risk-based assessment of capital requirements for originators and investors.

Another example, requesting public action was raised in an unpublished study by Panteia (2012, mimeo) on "*SME Loan Securitisation and Covered Bonds in the light of CRD IV and the Solvency II*

Implementing Measures". The study recommends, inter alia, towards the EC …"to support the SME loan securitisation as an important tool for banks to refinance SME loans" and "to set up a platform for promotion and execution of SME mezzanine securitisation (e.g. under EIF auspices)". Moreover, it includes recommendations from stakeholders (based on interviews with market participants) towards the EC, e.g. the "introduction of an EU wide, low cost, programme supporting investment in or guarantee of SME Securitisation".

On behalf of AFME, Oliver Wyman prepared the Report "Unlocking funding for European investment and Growth", based on in-depth interviews with borrowers, investors and banks in eight EU countries.[25] With regard to the topic of "improving access to finance for SMEs", the report summarises that "Interviewees believe that lending to small businesses (SMEs) is likely to remain primarily in the hands of banks due to the small size of transactions and the local nature of commercial relationships, although they say that non-bank sources such as fund managers could add some capacity over time. *Securitisation could play a larger role*, if the economics of SME loan securitisation can be restored, as an efficient way for banks to be able to free up capital and raise cash for further lending to existing or new SME borrowers. SMEs also said that it was not easy to understand the range of government and central bank schemes at national and European level. *Improved information and communications* would help them to understand what was available and how to obtain it and improve competition and transparency".

More specifically, the report says that "SME securitisation is currently not economic. Due to the relatively low interest margins on bank-originated SME loans and issuers needing to pay credit spreads on AAA securitisation tranches which are not economic to issuers, SME securitisations are typically not cost effective for banks. However, securitisation structures offer potentially valuable mechanisms to implement public sector support for bank-SME lending, through senior tranches (focused on funding), junior tranches (providing risk transfer), or a combination of the two. For banks, the securitisation of SME loans is seen to have significant potential for additional capital markets funding, but only if the economics of securitisation can be restored. For a variety of reasons, including capital charges on SME loans but also other factors, bank-SME loans have relatively low interest rates of around LIB + 200bppa or slightly higher, as compared to the rates which direct capital markets investors such as fund managers are currently originating SME loans for funding through investment funds. As a result, the interest rate on highly rated securitised tranches sold to investors must be sufficiently low for the cost of funding to be economic to the issuing bank. As a result, the economics of SME securitisation simply do not work for most banks, unless some type of public support is provided."

At its meeting on the 27/28th June 2013, the European Council discussed ways to boost investment and improve access to credit (European Council, 2013a). It called for the mobilisation of European resources including that of the EIB Group; and launched a new "Investment Plan" to support SMEs and boost the financing of the economy. In particular, the European Council agreed – inter alia – on the expansion of joint risk-sharing financial instruments between the European Commission and the EIB Group to leverage private sector and capital markets investments in SMEs. This initiative is called the *EU SME Initiative* and will be explained later in this paper; it should ensure that the volume of new loans to SMEs across the EU is expanded,

[25] 75 interviewees: 32 corporates, 26 investors, 7 banks as providers of funding, and 10 trade associations.

respecting the principles of financial soundness and transparency as well as the MFF ceilings. The Council, in consultation with the Commission and the EIB Group, will specify without delay the parameters for the design of such instruments co-financed by the Structural Funds, aiming at high leverage effects. The necessary preparations should be made to allow these instruments to begin operating in January 2014. The European Council welcomed the intention of the Commission and the EIB Group to implement them as a matter of priority.

UEAPME, as representative of SMEs reacted to this conclusion:[26] As a summary of UEAPME's position a reference can be made to one of UEAPME's Press Releases (UEAPME, 2013b) "(…), UEAPME will promote to all regions to use the new possibilities of all Structural Funds to support financial instruments for SMEs, especially loan guarantees and the securitisation of SME loan portfolios of banks to improve their capacity to lend additional money to SMEs. In this context, UEAPME President Almgren supported at the meeting of the European Council the new initiative of the European Commission and the European Investment Bank to blend money from the Regional Development Fund with money from the Commission Programmes COSME and Horizon 2020 to create an impactful instrument for the securitisation of SME loan portfolios. Addressing the Heads of States and Governments at the European Council, Almgren warned that *"It will depend on the national governments and the regional authorities to use this new possibility to support growth and jobs by improving access to finance. What is for sure, such instruments have higher leverage effects and multipliers than building another bridges or golf courses."*

This call to expand joint risk-sharing financial instruments between the Commission and the EIB Group to leverage private sector and capital market investments in SMEs has then been reiterated in the European Council meeting of the 24/25th October (European Council, 2013b). The new instruments should achieve high leverage effects, with the overall objective of expanding the volume of new loans to SMEs across the EU. Moreover, the Council asks to immediately start the work on further developing tools for the future - especially on securitisation, and encourages the Member States to participate with the greatest possible contribution. The new instruments should begin operating in January 2014 to accompany recovery, fight unemployment and reduce fragmentation in the initial years of the financial framework (European Council, 2013b).

The EU's Economic and Financial Committee (EFC) established a High Level Expert Group on Long Term Finance (HLG). The work of this Group focuses on developing concrete proposals for capital market instruments to stimulate and diversify the funding of SMEs and mid-cap enterprises and the financing of infrastructure projects. It also explores the role of multilateral (e.g. EIB) and national public investment institutions in catalysing private finance.[27] One focus of the HLG's work is to specify the design of the above mentioned EU SME Initiative.

[26] UEAPME is the employers' organisation representing the interests of European crafts, trades and SMEs at EU level. UEAPME is a recognised European Social Partner. As the European SME umbrella organisation, UEAPME incorporates around 80 member organisations from 34 countries consisting of national cross-sectorial SME federations, European branch federations and other associate members, which support the SME family. UEAPME represents more than 12 million enterprises, which employ around 55 million people across Europe. See http://www.ueapme.com/

[27] The Group is co-chaired by John Moran (Secretary General, Department of Finance, Ireland) and Alberto Giovannini (CEO, Unifortune). There are 18 members in the group, from national finance ministries, EU institutions, national development banks and the financial sector.

Against the background of these requests for public intervention we have to discuss whether public intervention on a European level is justified.

4.2 Justification for public and EU level intervention[28]

Economically, public intervention in the fields of entrepreneurship and innovation finds its justification primarily in the presence of a series of market, policy and institutional failures, such as innovation asymmetries, transaction costs and ineffective policy and institutional coordination. In particular

- Information asymmetries, transaction costs, and spill-overs
- Lack of policy coordination

__Information asymmetries, transaction costs, and spill-overs__

Information asymmetries are a key determinant of the problems experienced by SMEs in accessing funding, as they are the basis for a structural hesitancy of providers of SME finance. Transaction costs first and foremost tend to magnify the impact of information asymmetries in financial transactions, thereby aggravating the conditions faced by smaller firms.

Economic literature often discusses that in the area of access to finance for SMEs, a market imperfection/failure is not only present during a deep recession but also on an on-going basis as a fundamental structural issue. The reasons for the market failure relate to insufficient supply of capital (debt or equity) and inadequacies on the demand side. This market failure is mainly based on asymmetric information (in the case of debt: information gap between lender and borrower), combined with uncertainty, which causes agency problems that affect debt providers´ behaviour (see Akerlof, 1970 and Arrow, 1985).[29]

Asymmetric information is a more serious problem in SME financing than in banking activities of larger firms. OECD (2006) states that "The entrepreneur has access to better information concerning the operation of the business and has considerable leeway in sharing such information with outsiders. However, the entrepreneur is also likely to have less training/experience in business than those in a larger company, although more adapted to operating in an uncertain environment. Hence, it may be difficult for the outside provider of financing to determine whether the entrepreneur is making erroneous decisions or for the outsider to understand the business adequately. In addition, the entrepreneur may have incentives to remain opaque, not only in dealings with financiers, but also with outsiders such as regulators and tax authorities."

[28] This chapter uses inter alia thoughts raised in the HLG as well as ideas and concepts mentioned in several ex-ante evaluations for EU programmes to support SME financing.
[29] Agency theory/the principal-agent approach is often applied in economics literature for the analysis of relationships between lenders and borrowers (e.g. contract design, selection processes, credit constraints, etc.).

Information asymmetry can be reduced via three ways: a firm's ability to signal its credit worthiness (incl. an institutional assessment or rating by an independent agency and the provision of collateral), a strong relationship between lender and borrower, and through due diligence/lenders' examination (screening). Small enterprises, young companies or start-ups by definition have no track record, often only limited collateral, and no long standing relationship with lenders. One could even generalise or simplify that: the smaller the company, the bigger the information asymmetry and thus the higher the transaction costs in relative terms (Pelly and Kraemer-Eis, 2012).

Moreover, the use of collateral increases the cost of lending (from the perspective of the borrower, e.g. legal and administrative cost), and the collateral may be worth more to the borrower than to the lender. Credit guarantee mechanisms are intended to address these market failures as they reduce the financial loss of the lender in case of default of the borrower (OECD, 2013).

Positive spill-over effects are an additional justification for public action: SME activities and dynamics have positive spill-over effects that are spurred by SME financing (see e.g. CEB, 2013). Just to recall: SMEs are at the heart of European industrial R&D and innovation. Far from being the poor cousin of larger companies they are a vibrant and innovative part of the European economy. SMEs account for 99% of all firms in Europe, approx. two thirds of total private sector employment and play a disproportionately important role in generating employment.

These effects are important for economic growth, innovation and social inclusion and as such also important to reach the Europe 2020 objectives. These spill-over effects are not taken into account by private financiers and this - without public support - might lead, from an overall economic perspective, to a sub-optimal level of access to finance for SMEs.

Therefore, public intervention to improve SMEs' access to finance is justified because of market failure, caused by significant information asymmetries high transaction costs and spill-overs, and exacerbated by the credit crunch associated with the financial crisis. For debt finance in Europe, public intervention is needed to increase the likelihood that loans are made and guarantees extended to the benefit of SMEs. Otherwise, the current gap in the market between the demand and supply of loans and guarantees for SMEs is likely to persist, with banks remaining largely absent from higher risk lending.

Lack of policy coordination

Lack of policy coordination prevents the reaping of benefits associated with the dissemination of best practices and at the same time may lead to duplication of efforts and wasteful use of scarce resources. Lack of EU action, or the undertaking of fragmented or uncoordinated action by Member States alone, would limit and further hinder the competitiveness and innovation capabilities of European SMEs.

Moreover, existing barriers faced by SMEs would become even more complex, hampering the achievement of the Europe 2020 targets. Based on this, there is a strong need for EU wide initiatives. Taking into account the above arguments, the subsidiarity principle, according to which the EU is entitled to act only if "the objectives of the proposed action cannot be sufficiently achieved by the Member States" (Treaty of the European Union), is fully respected. In particular, it emerges that the Europe 2020 goals cannot be sufficiently achieved by a single Member State, either at regional or at local level, but can rather, by reason of the scale and effectiveness, be better achieved at the EU level. Following the application of the subsidiarity principle, EU action has to be proportional, in other words, efforts and means have to fully justify the goals. In this respect, given the large extent of the challenges faced by European economies, the size and scale of EU action is expected to generate positive impacts across Europe through crowding-in and multiplier effects.

<u>EU Added Value – providing support at the right policy level</u>

Policy support has to be provided at the most appropriate level, and consistency in support has to be ensured. In a world that is increasingly interlinked, government measures will generate effects that go beyond the sheer local, regional and national level. Multi-level governance means finding the most optimal combination of government intervention at all policy levels in order to create synergies which none of the policy actors will be able to achieve on their own. SME support policy can only be effective if a multi-level governance approach is applied both in designing and implementing as well as in evaluating the success of the policy.

As described above, a compelling case can be made for public intervention in enhancing the access to finance for SMEs. However, one must also justify why this type of public intervention is better carried out at EU level rather than at national level. Before analysing the reasons for EU intervention, one should first consider the legal basis for action at EU level.

The EU right to act comes from the Treaty on the functioning of the European Union, particularly on article 173, where it is stated that the EU action should be aimed at "encouraging an environment favourable to initiative and to the development of undertakings throughout the Union, particularly small and medium-sized undertakings".

From the identification of the legal basis for EU intervention, it emerges that entrepreneurship and innovation support measures do not constitute an exclusive competence of the EU. Therefore, EU actions in this area should not replace existing policies at national or regional level, but rather complement, coordinate or introduce specific measures if needed. In particular, the EU plays a key role in activating all policy areas and levers in an integrated way.

European added value is in reality a complex concept which has been the subject of much discussion. Nevertheless, there is broad agreement on a number of particular cases where EU intervention is justified. The case of action at the EU level relies essentially on the existence of five main sources for European Added Value, namely:

- <u>EU policy objectives and consistency</u>: Helping achieve EU policy objectives: EU-level financial instruments can support the achievement of the EU 2020 objectives by addressing market failures that lead to insufficient funding of SMEs being available from market sources, typically because the field is perceived as being too risky. In this sense, policy measures have to support the EU policy objectives. Moreover, different instruments have to be consistent.

- <u>Overcome market fragmentation:</u> The benefits associated with the strengthening of the Common Market, by overcoming persistent market fragmentation in important areas such as SME lending and securitisation. Existing public measures to fight the crisis and to enhance SMEs' access to debt finance helped in the past, but they are not sufficient. Moreover, the real kick-off of the revival of the SMESec market - which is a European market - with its benefits for SME financing - will depend on significant public support. Already the original development of SMESec in Europe has been spurred by stimuli from national and supranational support measures. Central instruments provide the advantage of having standards in place when it comes to products, such as established structures with defined eligibility criteria, reporting requirements, legal documentation. By building on the existing experience in setting up similar initiatives and sharing the experience among financial intermediaries, the implementation is more efficient.

- <u>Demonstration, signalling, and catalytic effects:</u> Centralised measures provide the possibility of achieving significant demonstration and catalytic effects, through the provision and dissemination of best practices, and the development of new paradigms (e.g. in the context of the revival of the SME securitisation market). Transferring skills and knowledge across frontiers could play a significant role in aligning Member States' policies, reducing the gap between European economies, and to a larger extent, enhancing competitiveness. If public support can for example contribute to the re-emergence of the primary European SME securitisation market, it could be an important element to enhance access to finance for SMEs in Europe.[30] In this context not only the volumes for the intervention matter, but also the positive signalling effect triggered by the public involvement and support. In times of a European crisis, a central EU intervention and the combination and better use of public resources carry a strong political message about the European construction that would not only be captured by investors and originators alike and would contribute to the creation of a broader and more standardised market, but it would also give a strong signal to the public of the joint will to fight the crisis and would enforce the message to markets.

  Centralised support measures under defined objectives and high quality standards spurs demonstration and signalling effects, i.e. typically the consistent application and promotion of best market practices. This fosters the qualitative development of a market and increases intermediary sophistication over time. It is expected that EU-level support can help reviving the appetite of investors for SME securitisation and contribute to market-building by making transactions viable in markets where without the EU support such transactions would not be feasible or cost-effective for originating financial institutions.

[30] However, this will only be to the benefit of SMEs if the freed-up capital / fresh liquidity is going to be used by the banks to finance the real economy (i.e. for new SME lending) and not for e.g. regulatory arbitrage.

- Multiplier effects and economies of scale: Structured EU-level financial instruments multiply the effect of the public budget by attracting other public and private financing along the implementation chain comprising entrusted entities (such as EIB Group), financial intermediaries (such as banks) and final beneficiaries (SMEs). Through risk sharing and structured guarantees, the EU level intervention may induce financial institutions to provide loans (or more loans) in cases where they would have not lent (or lent less) without the support measure.

  EU-level interventions can contribute to leverage national public and private resources, avoid duplication of efforts, and promote cooperation between MS. The ability to minimise risks in areas where initiatives at Member State level would be exposed to high risk of failure. The argument is particular relevant in the area of SME loan securitisation. Under the market conditions, described above, even in the case of the largest EU countries, purely national initiatives are likely to be limited to a relatively small number of operations, which would involve a significant concentration of risks, whereas for smaller Member States it might prove impossible altogether to undertake any action of a certain significance.

- Capacity building: In the case of SMESec, EIF's experience is unique and constitutes a valuable asset for supporting a potential re-start of the market. EU capital markets (and their need for transparency and standardisation) and the relative complexity of the securitisation techniques require considerable know-how and show the necessity for specialised institutions (see for more details of concerning the role of EIF as well chapter 5.2.1 below).

Efficient markets do not require public intervention. However, as outlined above, beyond the normal scarcity of credit for SMEs that would be typical at this point in the recovery, the confluence of a variety of austerity, growth, and regulatory initiatives may be compounding the difficulties. In particular, increased capital requirements for banks and insurance companies may be shrinking the supply of debt to private enterprises. Difficult access to finance for SMEs creates a significant barrier to innovation and growth for the entire economy (Pelly and Kraemer-Eis, 2012).

There are market imperfections for SME finance, serious enough to warrant the intrusion. This intervention to mitigate the "bottlenecks" must be conditional upon ensuring "additionality," i.e. not crowding out private activities, but rather serving as a catalyst for the entry of private capital in order to create self-sustainable markets in the long run. Based on the above assessment, it can be concluded that public and EU-level intervention is justified and that such a support would provides significant added value with regard to enhancing access to finance for SMEs.

5 Existing initiatives to revive the securitisation market

In order to avoid undue refinancing risks and significant reliance on central bank balance sheet, longer-term SME financing requirements may need to be addressed through a resuscitation of more traditional securitisation techniques (see box 2).

As mentioned above, in the current market, securitisation is virtually only funding driven: the most senior tranche is either placed or - more frequently - retained and used as collateral for ECB loans[31]. Despite some promising first attempts to revive this asset class, the primary SME market - both in terms of number of transactions and volumes placed with market investors - is still expected to remain well below pre-crisis levels for some time and the image of securitisation in general is still damaged (with related negative impact on the image of SMESec as well[32]), i.e. due to the understandably bad reputation of the US sub-prime products and the unfortunate negative association of the European structured finance markets with its US peers, despite the fact that the former performed substantially better than the latter.

Moreover, in the current market environment, the economics of SMESec transactions do not work for the originators if they want to place transactions on the primary market: either the spreads demanded by investors have to go down or the asset spreads charged from the SMEs will have to rise. Currently it is more attractive (i.e. cheaper) for banks to access ECB liquidity than to sell to investors (Fitch, 2013d; UniCredit, 2013b). However, at some point in time the ECB is going to retract the repo-possibilities – and a revival of the real SMESec market has to happen well before.

Box 2: How to avoid the bad experiences from the past

In the years running up to the crisis there were first signs also in Europe of a drift away from key principles and main success factors for SMESec – i.e. granular portfolios (highly diversified in terms of obligor concentration, sector diversification and regional distribution) and transparent structures – for example in the form of hybrid transactions (i.e. the so-called German Mezzanine CDOs) with non-granular portfolios, larger (mid-cap) borrowers and non-aligned incentive structures. The generally poor performance of these transactions provides lessons for the future of SMESec.

SME loans are, in principle, less homogenous than residential mortgages (with regard to size, legal forms, collateral etc.) and the underwriting criteria are less standardised. On the other hand SME loans are typically thoroughly analysed by credit experts and systems (e.g. most banks apply detailed (quantitative) internal rating methodologies on top of more qualitative assessments). Moreover, banks normally have a relationship banking approach and know their customers very well, thus enabling them to manage the risk of the customer over the long term in contrast to the more automated lending decisions seen in the mortgage and credit card markets. This distinguishes SMESec from those other securitised asset classes.

[31] A few "synthetic" risk transfer transactions backed by SME pools and aimed at capital relief have been executed by large banks only on a private/bilateral basis with specialised investors.

[32] The contagion effects for SMESec have been discussed in more details in EIF's Working Paper 2010/7: http://www.eif.org/news_centre/research/index.htm (Kraemer-Eis et al., 2010).

Box 2 continued:

As a result, and as "lessons learnt", some key features of successful SMESecs can be summarised:

- Granular, diversified portfolios (i.e. with regard to single obligor exposure, sectors, regional distribution);
- Transparent and standardised structures (and no multiple securitisations like CDO of CDOs/CDO of ABS);
- Proper and transparent incentive structures in order to avoid moral hazard; originators have to have sufficient "skin in the game";
- Loans originated in line with relationship banking and in line with adequate credit/credit risk standards; no "originate-to-distribute" practices[33];
- Investors/guarantors should perform their own analysis/due diligence and should not be only "external rating driven".

Considering these criteria: properly applied, SMESec

- can enhance access to finance for SMEs;
- is a replicable tool for SME support;
- is an efficient way of using public resources that provides a multiplier effect.

In order to restore confidence in this market and to revive primary market activities, greater standardisation and transparency is needed, as well as the avoidance of overly complex structures. A combination of market driven signalling approaches and public support through measures addressing the key (real and perceived) risks, e.g. through purchase of junior tranches in properly structured transactions is needed – with the overall objective to attract private investors.

5.1 Actions to improve transparency

There have also been a couple of additional initiatives that aim to remove current hurdles in the market and help reigniting issuance and return to more normal conditions; among which one should mention the development of the European Data Warehouse that will deal with investor's complaints about the lack of transparency and standardisation of ABS data, as well as the Prime Collateralised Securities (PCS) initiative which represents an industry-led project that is looking to create a sustainable securitisation market with standardised criteria based on simplicity, quality and transparency. The EIB Group has been actively involved from the inception in these two initiatives as far as SMESec is concerned.

[33] Securitisation should not lead to overly soften credit standards. According to Carbo-Valverde et al. (2011) the Spanish "housing bubble was partly funded via spectacular developments in the securitisation market leading to looser credit standards and subsequent financial stability problems".

5.1.1 DataWarehouse – The Loan Level Initiative

In this context, the ECB intends to progressively introduce requirements in its collateral framework for ABS originators to provide loan-level data on the assets underlying these instruments and to establish a data warehouse to process, verify and distribute standardised securitisation information to market participants. In addition to improved transparency for the ABS markets this initiative shall facilitate the risk assessment of ABSs as collateral used by Eurosystem counterparties in monetary policy operations:

The Governing Council of the ECB decided in 2010 to establish loan-by-loan information requirements for asset-backed securities in the Eurosystem collateral framework. Loan-level data will be provided in accordance with a template which is available on the ECB's website, at least on a quarterly basis. To allow the processing, verification and transmission of the data, the Eurosystem encourages market participants to establish the necessary data-handling infrastructure. When the necessary data-handling infrastructure has been established, the provision of loan-by-loan information will become an eligibility requirement for the instruments concerned. The Eurosystem continues to accept securities not meeting the new information criteria until the obligation to submit loan-level data comes into force. The "SME template" is applicable to all SME transactions with the exception of those where the underlying assets are constituted by leasing contracts. The template covers both stand-alone and revolving structures. The Eurosystem introduced the loan-by-loan information requirements for residential mortgage-backed securities (RMBSs) first (03.01.2013) and then gradually to other asset classes: SME transactions (03.01.2013), commercial mortgage-backed securities (CMBSs, 01.03.2013) and to consumer finance ABSs, leasing ABSs and auto loan ABSs (01.01.2014). A nine-month phasing-in period applies for each asset class. Where loan-level data are incomplete on that date, they must gradually be completed in the course of that transitional period.

According to the ECB (ECB, 2013d) SME ABS for which the mandatory level of compliance with reporting requirements has not been attained and for which the data provider has neither given an explanation for that non-compliance nor provided action plan for achieving full compliance, become ineligible for use as Eurosystem collateral; the Eurosystem may temporarily accept non-compliant SME ABS as eligible collateral on a case-by-case basis and subject to the provision of adequate explanations for the failure to achieve the mandatory score.

The Loan Level Initiative led to the creation of the European Data Warehouse GmbH. This new company, based in Frankfurt/Main (Germany), has been established independent of and external to the Eurosystem; investors are global banks and institutions. It is going to facilitate the reporting of loan-level data of ABS transactions and will ensure that the data is made available to market participants in order to increase transparency.

This attempt will make more information available to market participants and it is expected that it contributes to the re-start of the markets. However, as always if medicine shall help: it is a matter of doses and it has to be seen how this approach develops; too many requested details could hamper the development of the SMESec market.

5.1.2 Prime Collateralised Securities

The European securitisation industry has taken a proactive response by providing funding for the development of a quality label, to distinguish a defined set of eligible high quality securitisations from those which do not have the label. The Prime Collateral Securities (PCS) initiative aims at establishing certain SME securitisations as a brand with key attributes such as quality, simplicity, transparency and liquidity (see AFME, 2013c). PCS, officially kicked-off on the 14. November 2012, is an industry-led, non-profit initiative to develop a label for high quality securitisations. The goal of the label is to improve

- quality (by limiting current eligibility to only four asset classes – SMEs and leases, auto loans, high quality residential mortgages, and consumer loans/credit cards),
- standardisation and simplicity (no re-securitisations/CDO squared),
- and transparency, through best industry practices on information reporting.

Various policymakers including central banks, the EIB Group and a regulatory authority participated as observers in the development of PCS.[34] In addition to the "signalling" of the label, PCS has the goal to ask policymakers to carefully review the criteria for PCS and its performance and, if they take a favourable view, to create regulatory incentives for the purchase of these types of high quality securitisations (AFME, 2013c).

5.2 SMESec support with EIF intervention

Already the original development of SMESec has been spurred by stimuli from national support schemes, such as KfW's Promise platform in Germany and Spain's FTPYME securitisation scheme. Supranational support through the EIF (as guarantor) has played a key role in the development of the European SMESec market before the crisis. Also for the future, the revival of the market in the aftermath of the financial crisis is expected to be driven by national and supranational support.

5.2.1 Strengthened "normal" EIB Group activities

Integrated EU capital markets (and their need for transparency and standardisation) and the relative complexity of the securitisation techniques require considerable know-how and show the necessity for specialised institutions. As an established and respected player in the European market, EIF can play a role via market presence, reputation building, and signalling. It typically credit enhances mezzanine and senior tranches of SMESec transactions either with embedded or bilateral guarantees. The respective tranches are enhanced with the EIF's AAA/Aaa rating and investors in the guaranteed tranches can benefit from EIF's risk weighting of 0% (MDB status/AAA rating). In addition to the direct benefits of its guarantees, other factors of EIF's involvement can play an important role in facilitating the execution of a securitisation transaction:

[34] Details on the Prime Collateralised Securities (PCS) initiative, set up by AFME and the European Financial Services Round Table (EFR) in 2012 but which now has an independent government structure, are available at www.pcsmarket.org

- EIF's involvement can facilitate placement of tranches with investors. From the originator's point of view, EIF reduces uncertainty and supports the marketing of a deal through its "anchor" investor status.
- Smaller banks profit from EIF's experience and knowledge of the SME securitisation process (support and spread of best market practise). Usually, EIF is involved very early in the transaction and can assist the originator. The EIF facilitates (on average) overall lower transaction costs.
- EIF acts in the "traditional" securitisation markets and with "traditional" key players, but expands the idea of SMESec into non-core market countries (e.g. Central and Eastern Europe), and to new originators.
- In general, EIF facilitates standardisation, requires high transparency levels, and spreads best securitisation market practise.

The "EIB Group ABS initiative for SMEs" is a new approach with the objective to restart the SMESsec market. It is an initiative launched by the EIB Group (EIB and EIF) in 2013 to increase its involvement in ABS and facilitate the execution of SMESec for originators. It combines EIB investments in senior SME-backed ABS notes at favourable conditions, with EIF guarantees for other notes of the same ABS, to make them more attractive to market purchasers.

This facility for SMEs will enhance EIB Group's external effectiveness in the priority area of SME lending and better use complementarities of EIB and EIF in the ABS domain. EIB Group's involvement is expected to encourage originators to initiate the launching of further new ABS transactions by facilitating deal execution through increased underwriting capacity and provision of credit enhancement to third party investors.[35]

5.2.2 SME Covered Bonds

Due to the challenges that the SME ABS market has been facing since the crisis, financial institutions have been seeking alternative means of funding SME loans. Commerzbanks' issuance of a structured SME covered bond has attracted quite a lot of coverage and renewed the discussion of the participation of SME loans in the covered bond space, although this is a topic of hot debate at the moment. However, currently the only market in Europe, where bank bonds backed by SME receivables are covered by the national covered bond legislation, is Turkey, where EIF has actually been active in the SME covered bond space. Discussions to introduce a respective regulation seem to place in other countries as well, e.g. in Italy and Austria. EIF has been following with keen interest those developments and is engaged in a dialogue with a number of parties to evaluate the potential involvement in future transactions.

Moreover, in France a scheme is under discussion and development under the lead of the Bank of France to help banks to package SME loans into tradable securities via a special purpose vehicle (SPV). The approach combines elements of securitisation (i.e. French Fonds Commun de

[35]It is foreseen to partially combine this EIB Group initiative with the EU SME Initiative, presented below.

Titrisation (FCT) rules) and the covered bonds law (i.e. Societiés de Financement de l'Habitat (SFH)), in order to boost SME funding (Sanderson, 2013; Deen, 2013).

These transactions can help to support SME financing via funding advantages for the originating banks, and it might well be that in many countries legislators are going to introduce covered bonds legal frameworks. EIF would welcome the further development of this segment, participated in two SME covered bond transactions in Turkey, and is working on some other transactions of this kind.

5.2.3 EC/EIF activities - the CIP Securitisation Window

EIF is trying to stimulate the market having participated in transactions, including from a number of lower rated EU countries that are currently facing more challenges accessing the public markets. One concrete example to provide capital relief is represented by the second loss protection transactions recently closed by EIF under the European Commission's Competitiveness and Innovation (CIP) Programme: EIF has signed in March this year the first two transactions under the so called *CIP Securitisation Window* with UniCredit Italy on two portfolios originated by UniCredit Italy together with, respectively, Federconfidi and Federascomfidi, two Italian mutual guarantee associations (federation of Confidi).

Under the CIP securitisation window, EIF provides, in the context of both, cash and synthetic SME securitisation transactions, guarantees on tranches with low layers of credit enhancement. The objective is to facilitate access to capital markets for unrated or low rated institutions, such as smaller banks and to find alternative solutions to allow financial intermediaries to circulate funding in the SME market. The aim of the CIP Securitisation product is to generate additional financing for SMEs, hence it combines an unconditional and irrevocable guarantee on an existing portfolio of loans with a separate undertaking to build up a new portfolio of SME loans (under a separate "Additional Portfolio agreement"). In exchange for the guarantee, originators undertake to create a new portfolio of SME financing (known as the *Additional Portfolio*) during an agreed period. The required size and composition of this portfolio depends on the size and the seniority of the guaranteed tranche. The Additional Portfolio must contain medium- or long-term financing to SMEs. In case the target volume of the additional portfolio is not achieved, a commitment fee would become due, while the guarantee on the securitisation transaction remains in place.

Thanks to EIF's intervention taking second loss risk alongside a first loss tranche taken by the Confidi (and partially retained by Unicredit), UniCredit and the participating Confidi have reduced their respective capital requirements. This is particularly important during the current transition period as many Confidi decided to be regulated as a bank. In addition, UniCredit can free up its credit lines of the participating Confidi thanks to the transaction and therefore increase the volume of new loans with the same Confidi. The transactions refer to two granular portfolios of loans originated by UniCredit and partially guaranteed on a loan by loan basis by Confidi. While the Confidis cover part of the first loss piece (transforming their loan by loan guarantees into a first loss portfolio guarantee), EIF guarantees the second loss piece. As required under the CIP securitisation window, UniCredit and, respectively, Federconfidi and Federascomfidi commit to increase the loan volume granted by UniCredit and guaranteed by the Confidi by a multiple of approximately 15 times the amount of capital released by the transaction. The transactions present the unique feature of aiming at strengthening the Italian mutual guarantee system, in a period where SMEs suffer most from the lack of bank financing and the Confidi's guarantee capacity has been eroded by the deteriorating credit quality of their guarantee portfolios.

The deal structure can be replicated in other parts of Europe and also scaled up to help stimulating SME lending.

The COSME programme, specifically created for small and medium-sized businesses, will be a funding instrument which will largely continue the activities under the current CIP, also the securitization activities.

5.2.4 EC/EIB Group activities - the EU SME Initiative

We mentioned above the European Council conclusions of June 2013 and October 2013 (European Council, 2013a and b). These conclusions support the proposal to explore various options to support lending to SMEs in the new Multiannual Framework. In this context, the proposal for the EU SME Initiative has been developed.

The SME Initiative is a joint initiative between the European Commission and the EIB Group which aims at stimulating SME lending (loans/leases) through financial institutions. The SME initiative would combine budgetary contributions from Structural Funds (ESIF) and other EU programmes (COSME/Horizon 2020) with EIB Group's own resources. The initiative also aims at stimulating private sector capital market investments in SMEs and reducing fragmentation across Europe. It is underlined that the SME Initiative is at an early stage and not an approved initiative. Further, it would only become available in those countries which contribute ESIF to the initiative.

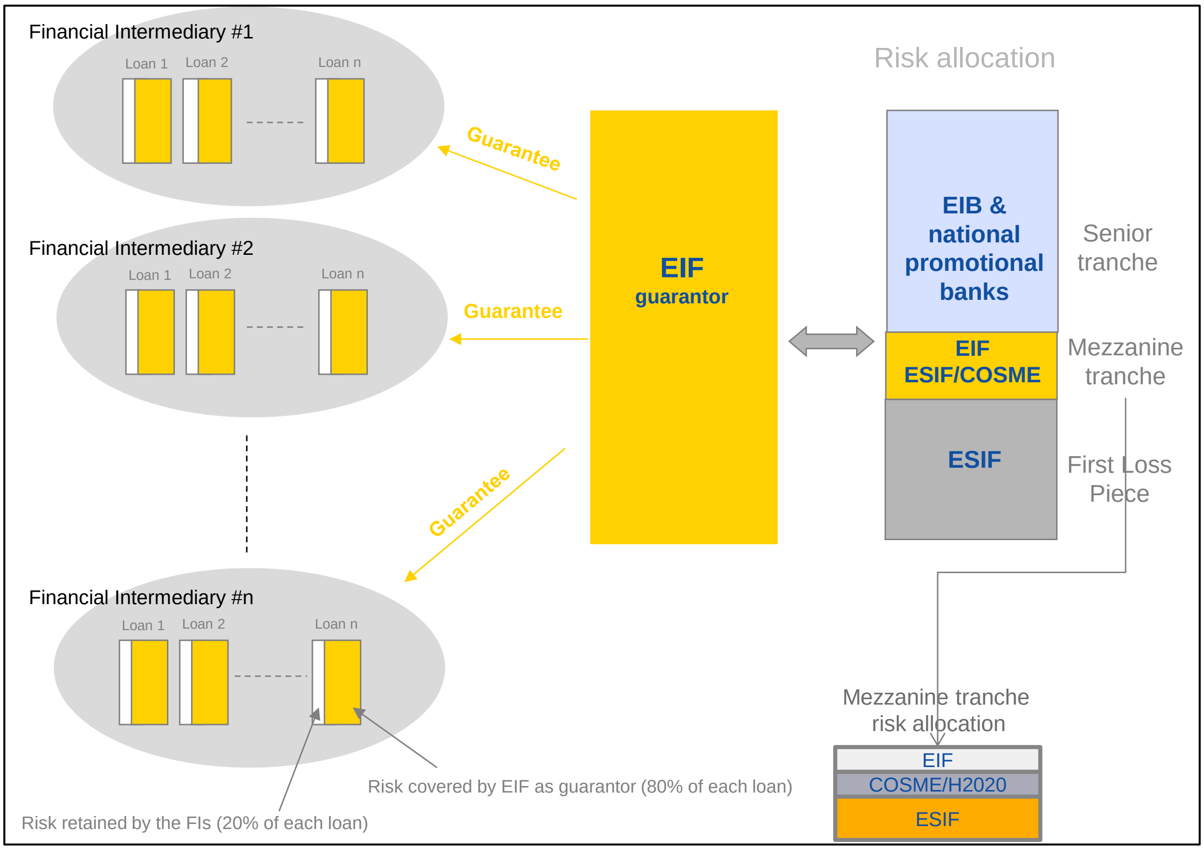
There are two Joint Instruments envisaged:

- a "guarantee facility" for new SME loans/leases (Option 1); and
- a "joint securitisation instrument" (Option 2), allowing for the securitisation of existing and new SME loans/leases.

Option 1 – Guarantee Facility

Under this instrument, financial institutions would receive partial guarantees (up to 80%) from EIF (AAA and 0% risk-weighted) for their new SME loans. Financial institutions may also receive funding from the EIB under a separate agreement along the EIF guarantee. The risk taken by EIF under the guarantees would be shared, on a portfolio basis, between EU funds, which would cover the first losses, and the EIB Group. National promotional banks may also participate alongside the EIB Group.

Figure 9: Schematic representation of Option 1



Source: EIF

Terms and conditions of the loans included in the guaranteed portfolio shall reflect the attractive rates at which the guarantee is provided to the financial intermediaries. The SME loan agreements shall also highlight the EU support (and other related features such as audit rights, etc.) for the portfolios to be built up (under both Options).

The instrument shall be compatible with the legal framework governing the COSME and HORIZON 2020 programmes of the European Commission. COSME aims at supporting SMEs, whilst HORIZON 2020 aims at supporting innovative enterprises (SMEs and Small MidCaps). Depending on which EU programme is used to support a transaction, eligible Final Beneficiaries will have to comply with the eligibility criteria set out under the applicable EU programme, as follows:

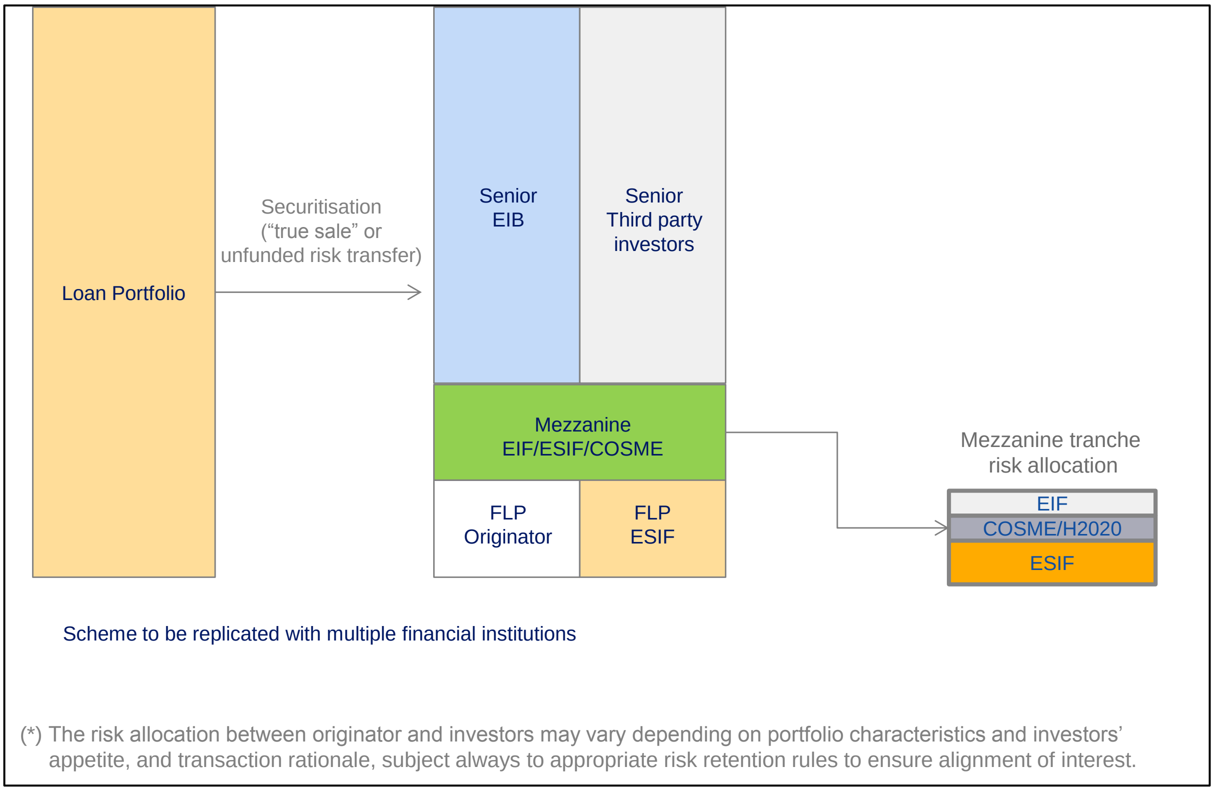
- COSME: viable SMEs facing difficulties in accessing finance either due to their perceived high risk or their lack of sufficient available collateral;
- HORIZON 2020: all types of SMEs with an innovation potential.

Option 2 – Joint Securitisation Instrument

Option 2, foresees the securitisation transactions backed by SME loans either through the sale of the portfolio to a dedicated vehicle ("True Sale") or through synthetic risk transfer. EU funds would cover the first losses. The EIB Group, alongside national promotional banks and other private investors, would subscribe or guarantee the notes issued or the tranches of a synthetic transaction.

Originators would retain an interest in the junior tranche in order to ensure the necessary alignment of interest and a focus on performing loans to viable companies. Subject to regulatory requirements relating to capital relief purposes, the originator's "skin in the game" is evidenced in the chart below by the assumed retention of 50% of the First Loss Piece.

Figure 9: Schematic representation of Option 2



Source: EIF

In contrast to Option 1, where only new loans can be guaranteed, under Option 2 existing loans can be securitised (yet with new loans possibly included through replenishment). In exchange, financial institutions would be obliged to originate an adequate volume of new SME loans (Additional Portfolio).

Terms and conditions of the loans included in the Additional Portfolio shall reflect the attractive rates at which funding/capital relief is provided to the financial intermediaries through the securitisation. The SME loan agreements shall also highlight the EU (indirect) support (and other related features such as audit rights, etc.) for the portfolios to be built up (under both Options).

The instrument shall be compatible with the legal framework governing the COSME and HORIZON 2020 programmes of the European Commission: COSME aims at supporting SMEs, whilst HORIZON 2020 aims at supporting innovative enterprises (SMEs and Small MidCaps).

Depending on which EU programme is used to support a transaction, eligible Final Beneficiaries (i.e. SMEs benefitting from the new loans included in the Additional Portfolio) will have to comply with the eligibility criteria set out under the applicable EU programme, as follows:

- COSME: all types of SMEs;
- HORIZON 2020: all types of SMEs with an innovation potential.

Currently, a market testing for the EU SME Initiative is on-going, as well as an ex-ante assessment (as required under the Common Provisions Regulation). Market participants of the above mentioned HLG and stakeholders consulted by the experts expressed strong interest in such a European financing initiative as it promises to overcome limitations linked to national programmes, such as different structures, policies and availability for SME finance across Member States.

5.2.5 Other activities

EIF has developed various forms of guarantee interventions which now include also unfunded products, such as liquidity facilities. An example of the implementation of such guarantee products is a deal that EIF has executed with Instituto de Credito Oficial in Spain (ICO) in connection to a selected portfolio of liquidity facilities on a number of multi-Cedulas transactions. EIF is continuously examining ways to enhance its SME risk financing activities in its strive to enhance access to finance for SMEs across Europe to help them innovate and grow.

6 Concluding remarks

Despite some positive signs Europe's sluggish and uneven economic performance continues and there are a number of downside risks. Top issues are still the concerns surrounding the large funding requirements of sovereigns and banks. Fiscal consolidation in many advanced economies is important to ensure future growth, however it is also a burden for economic growth prospects in the short term. Moreover, the overall business environment of European SMEs further deteriorated and the imbalances between the EU Member States are significant.

Even if this difficult economic situation reduced corporate *demand* for loans, balance sheet and risk considerations of banks led to a more restrictive lending behaviour on the *supply* side. These problems are more pronounced in those countries that are most affected by the financial and sovereign-debt crisis.

As mentioned above, there have been a number of comments from policy makers and the ECB about current discussions and potential initiatives in connection to the SME markets and *securitisation*. There are various task forces that are actively looking at ways of providing credit to the real economy especially for those countries who are suffering the most from the crisis. If public support can contribute to the re-emergence of the primary European SME securitisation market, it could be an important element to enhance access to finance for SMEs in Europe.[36] In this context not only the volumes for the intervention matter, but also the positive signalling effect triggered by the public involvement and support. However, this will only be to the benefit of SMEs if the freed-up capital / fresh liquidity is going to be used by the banks to finance the real economy (i.e. for new SME lending) and not for e.g. regulatory arbitrage.

Quite unusually, we conclude this time with an "external" statement. The ECB (ECB, 2013e) commented in its September Monthly Bulletin in a way that fits perfectly as a summary of the messages given in our paper: "*several EU institutions have been exploring joint policy initiatives to promote lending to SMEs that would be based on reactivating the ABS market for such loans. The institutions could leverage their respective expertise (for example by providing guarantees to ABS transactions or ring-fencing public funds for specific purposes) to play a catalytic role in this regard. Such initiatives may be helpful for reducing spreads in certain jurisdictions, for facilitating new issuance and the transfer of risks from bank balance sheets, and finally for stimulating lending to firms and households, where this has become severely impaired. In addition, it is important to make further efforts in developing simple and standardised ABS products, which can benefit investors and provide regulators with comfort from a prudential perspective. However, all these initiatives are not a silver bullet for restoring loan growth and reactivating the ABS market, and their success will also depend on wider economic developments and the return to health of the EU banking sector.*

[36] It is important not only to look at banks when analysing SMESec but equally to leasing companies and trade receivables financing which form part of the SME securitisation market. It can be expected that in particular leasing companies are going to play a larger role in the market for SME finance as banks will at least partially retreat. Given that bank financing is and will be less available for leasing companies post crisis, it can be expect that SME securitisation will be particularly relevant in the leasing area. See for more information on the importance of leasing for SMEs finance: Kraemer-Eis and Lang (2012).

The European ABS market has the potential to play a long-lasting and important role in European funding markets and real economy financing. Nevertheless, the turbulence in recent years has led to a number of regulatory initiatives that will play a key role in the viability of the market. These warrant careful consideration in order to ensure that important distinctions across jurisdictions and relative to other assets are sufficiently taken into account. Investor uncertainty and the challenging economic circumstances in many countries continue to present additional challenges. In this context, initiatives to improve transparency and standardisation, with the aim of enabling investors to better assess risk, and to support the real economy are crucial to attract market participants and reactivate the European ABS market."

ANNEX

Annex 1: Securitisation glossary

- **Credit Default Swap:** An agreement used in synthetic securitisations where the originator (protection buyer) sells the credit risk of an underlying portfolio to a counterparty (protection seller) without transferring the ownership of the assets.
- **Credit Enhancement:** Refers to one or more measures taken in a securitisation structure to enhance the security, the credit quality or the rating of the securitised instrument, e.g. by providing a third party guarantee (such as the EIF guarantee). The credit enhancement could be provided in the form of:

  (i) Structural credit enhancement (tranching of the transaction in senior, mezzanine and junior tranches);

  (ii) Originator credit enhancement (cash collateral, profit retention mechanism, interest sub-participation mechanism);

  (iii) Third party credit enhancement (eg EIF or monoline insurers).
- **Credit Linked Notes (CLN):** A security issued by an SPV (or directly from the balance-sheet of the originator) credit-linked to the default risk of an underlying portfolio of assets. Usually used in synthetic securitisations for the mezzanine tranches of a transaction.
- **Collateralized loan obligations** (CLOs) are a form of securitisation where payments from multiple middle sized and large business loans are pooled together and passed on to different classes of owners in various tranches.
- **First Loss Piece:** Part of a securitisation transaction which is usually kept by the originator (as an "equity piece") and which covers the risk of first loss in the portfolio. Its size is a function of the historical losses, so as to protect the investors against the economic risk (estimated loss) of the transaction.
- **Issuer:** Refers to the SPV which issues the securities to the investors.
- **Mezzanine Risk:** Risk or tranche which is subordinated to senior risk, but ranks senior to the First Loss Piece.
- **Originator:** The entity assigning receivables in a securitisation transaction (funded transaction) or seeking credit risk protection on the assets (unfunded transaction).
- **Primary market:** The market in which securities are issued.
- **Secondary market:** The market where issued securities are traded.
- **Senior:** The class of securities with the highest claim against the underlying assets in a securitisation transaction. Often they are secured or collateralised, or have a prior claim against the assets. In true sale structures they rank senior in the cash flow allocation of the issuer's available funds.
- **Servicer:** Refers to the entity that continues to collect the receivables, enforcement of receivables, etc. Generally, the originator is also the servicer.
- **Special Purpose Vehicle (SPV):** Issuing entity holding the legal rights over the assets transferred by the originator. An SPV has generally a limited purpose and/or life.
- **Subordinated:** The classes of securities with lower priority or claim against the underlying assets in a securitisation transaction. Typically, these are unsecured obligations. They are also called Junior (or Mezzanine) notes and bonds.
- **Synthetic securitisation:** A transaction where the assets are not sold to an SPV but remain on balance sheet; and where only the credit risk of the assets is transferred to the market through credit default swaps or credit linked notes.
- **Tranche:** A piece, a portion or slice within a structured transaction.
- **True sale:** It refers to the separation of the portfolio risk from the risk of the originator, i.e. there is a non-recourse assignment of assets from the originator to the issuer (special purpose vehicle). To be contrasted with synthetic securitisations where only the underlying credit risk is transferred.
- **Whole Business Securitisation (WBS):** Securitisation of the general operating cash flow arising from a certain line or area of the business of the originator over the long term.

Annex 2: List of acronyms

- ABCP: Asset Backed Commercial Paper
- ABS: Asset Backed Securities
- AFME: Association for financial markets in Europe
- AIFM: Alternative Investment Fund Manager
- BCBS: Basel Committee on Banking Supervision
- BLS: Bank Lending Survey
- bp: basis point(s)
- bppa: basis point per annum
- CDO: Collateralized Debt Obligation
- CEO: Chief Executive Officer
- CH: Cédulas Hipotecarias
- CIP: Competitiveness and Innovation Framework Programme
- CLN: Credit Linked Note
- CLO: Collateralized Loan Obligation
- CMBS: Commercial Mortgage Backed Securities
- COM: European Commission (also: EC)
- COSME: Programme for the Competitiveness of enterprises and SMEs (COSME) 2014-2020
- CRA: Credit Rating Agency
- CRD: Capital Requirements Directive
- CRR: Capital Requirements Regulation
- EBA: European Banking Authority
- EC: European Commission (also: COM)
- ECB: European Central Bank
- EFC: Economic and Financial Committee
- EFR: European Financial Services Round Table
- EIB: European Investment Bank
- EIF: European Investment Fund
- EMEA: Europe, Middle East, and Africa
- EMIR: European Market Infrastructure Regulation
- ERDF: European Regional Development Fund
- ESBFO: European Small Business Finance Outlook
- ESIF: EU Structural and Investment Fund
- EU: European Union
- EU27: the 27 EU Member States
- FCT: Fonds Commun de Titrisation
- FLS: Funding for Lending Scheme
- FTPYME: Fondos de Titulización de Activos para PYME (Asset Securitisation Funds for SMEs)
- GDP: Gross Domestic Product
- GmbH: Gesellschaft mit beschränkter Haftung
- HLG: High Level Group
- HY: Half Year
- H-2020: Horizon-2020
- ICO: Instituto de Crédito Oficial
- IOSCO: International Organisation of Securities Commissions
- KfW: Kreditanstalt für Wiederaufbau
- LGD: Loss given default
- LIB: Libor – London Interbank Offered Rate
- LLI: Loan Level Initiative
- LTRO: Longterm Refinancing Operation

- MDB: Multilateral Development Bank
- MFF: Multiannual Financial Framework
- MFI (in the context of ECB): Monetary Financial Institutions
- MS: Member State
- NFC: Non-financial corporation
- OECD: Organisation for Economic Co-Operation and Development
- pa: per annum
- PCS: Prime Collateral Securities
- RMA: Research and Market Analysis
- RMBS: Residential mortgage backed securities
- RWA: Risk weighted assets
- R&D: Research and Development
- SAFE: Survey on the Access to Finance of SMEs in the euro area
- sf: Structured Finance
- SFH: Societiés de Financement de l'Habitat
- SF/CF: Structural Fund / Cohesion Fund
- SME: Small and medium sized enterprise
- SMESec: SME Securitisation (comprising transactions based on SME loans, leases etc.)
- SPV: Special Purpose Vehicle
- UEAPME: European Association of Craft, Small and Medium-sized Enterprises
- UK: United Kingdom
- US: United States (of America)
- WBS: Whole Business Securitisation

Annex 3: Global regulations affecting securitisation (pro's and con's according to AFME)

Regulation	Date	Advantages	Disadvantages
Capital and non-risk-based prudential measures			
Basel proposals for revised RWA	Proposed December 2012; discussions continuing.	Intend to address perceived misalignment of bank capital with risk during the financial crisis. Aim to increase risk sensitivity, remove cliff effects, reduce reliance on ratings.	Objectives not achieved and will severely discourage issuance and investment by banks. Not risk sensitive - capital requirements vary only within a narrow band between caps and floors. Cliff effects remain. Reliance on ratings not eliminated. Complex, difficult to implement, and inconsistent framework.
EU Solvency II proposals	Discussions continuing.	Modernises risk management for insurance company investors.	Extremely harsh capital charges (ten times that for identically rated covered bonds) will and have driven insurance company investors away.
BCBS proposals for recognising the cost of credit protection purchased	Proposed March 2013; discussions continuing.	Intend to prevent banks from reducing capital requirements while deferring recognition of expected losses and without transferring credit risk to third parties.	While capturing a small number of transactions deemed abusive, the rule will have a disproportionate effect. Concerns should be addressed by regulatory supervision and changes to accounting standards, without amendments to Pillar 1 rules.
Basel proposals for measuring and controlling large exposures	Consultation paper issued March 2013 for response June 2013.	Non-risk based measure intended to complement regulatory capital rules.	Proposes a look-through approach requiring information which is often not available and imposes substantial compliance burdens not balanced by prudential benefits. Subjects natural persons to the Large Exposure limit.
EU proposals for measuring and controlling large exposures (draft RTS under CRR)		Non-risk based measure intended to complement regulatory capital rules.	As above. Exceedingly conservative approach which ignores credit enhancement. Reduces existing "granularity exemption" to 0% bringing natural persons within scope.
Basel proposals for leverage ratio	Proposed July 2013; work in progress	Intention is to create a non-risk based measure for prudential framework.	Including securitisations which achieve significant risk transfer is overly conservative and will make it harder for banks to deleverage.

Liquidity			
Basel Liquidity Coverage Ratio	In force as of January 2013. Consultation on disclosure standards announced July 2013.	Some limited types of RMBS included.	Many other types of "real economy" assets such as auto, consumer and SME loans remain excluded. Will reduce investor appetite for high quality ABS.
EU Liquidity Coverage Ratio (CRR)	Work in progress: expected to be in force in 2015	Primary text of CRR allows for inclusion of certain securitisations.	Calibration delegated to EBA. Discussions continue, but progress is slow.
EU outflow calibrations for liquidity lines to ABCP conduits	Work in progress: expected to be in force in 2015	Intend to reduce risk of liquidity runs on banks.	As above. Proposals equated multi-seller ABCP conduits funding real economy assets with "arbitrage" SIVs. Calibration not evidence-based and harsh.
Regulation	Date	Advantages	Disadvantages
Securitisation-specific			
EU bank investor due diligence requirements (CRR)	Introduced January 2011 but under review as of May 2013	Forces less investor reliance on CRAs.	Increases investor compliance process.
EU risk retention requirements for banks (CRR)	Introduced January 2011 but under review as of May 2013	Mandates alignment of incentives, although most originators already held "skin in the game".	Places burden of compliance on investors and discourages new investors from entering the market. Uncertainty created by May 2013 proposals to re-write the rules.
EU equivalent due diligence and risk retention requirements for insurance company investors and AIFMs	July 2013 and on-going	As above, provisions are designed to be equivalent to bank rules.	Rules are not consistent and (for AIFMs) require a higher due diligence burden which will drive AIFM investors away.
ECB and Bank of England increased investor reporting, standardised definitions and prospectuses, cash flow models	Throughout 2011, 2012 and 2013	Improves investor confidence through better data granularity and transparency.	Increased IT and compliance costs for issuers. Need consistency. Overlapping between different sets of disclosure requirements duplicates the compliance burden.

EU increased disclosure requirements (Article 8(b) Regulation 1060/2009)	Mid-2014	Stated objective is to increase transparency.	High standards of transparency already delivered and mandated by law (CRR - see above). Parallel regime unnecessary and creates compliance uncertainty.
EU draft proposals for money market funds	Not yet published	Promulgated under "shadow" banking initiative to protect MMFs from "runs".	Initial draft proposal was for an outright prohibition on money market funds from buying any ABS or ABCP. Very negative signalling, will drive MMF investors away.
IOSCO and Basel proposals for initial and variation margin on non-centrally-cleared derivatives (also EMIR in Europe)	TBC	Increases collateral available to counterparties; reduces systemic risk.	Securitisations simply do not have extra collateral for initial nor variation margin.
US Dodd-Frank Section 941, risk retention	TBC	Forces issuer "skin in the game".	Potential impact of certain provisions on economics of securitisation.
US Dodd-Frank Section 621, conflicts of interest	TBC	Prohibits material conflicts of interest.	Broad language may make impossible some typical risk management and securitisation activities.
US Dodd-Frank Section 939F, credit rating agency board	TBC	None.	Disrupts securitisation process. Adds costs without corresponding benefits.
US SEC Regulation AB2	TBC	Enhances issuer disclosure and reporting standards. Changes to securitisation documentation and structure.	Increases compliance costs and impacts utility of non-registered ABS market.
Asia (Monetary Authority of Singapore) notice on risk based capital adequacy requirements for banks incorporated in Singapore	September 2012	Increased disclosure.	TBC

Source: AFME (2013e)

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