Revitalizing SME Securitization in Europe

ABAC Malaysia - SME Finance Forum
Workshop on Innovative Financing for SMMEs

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Background

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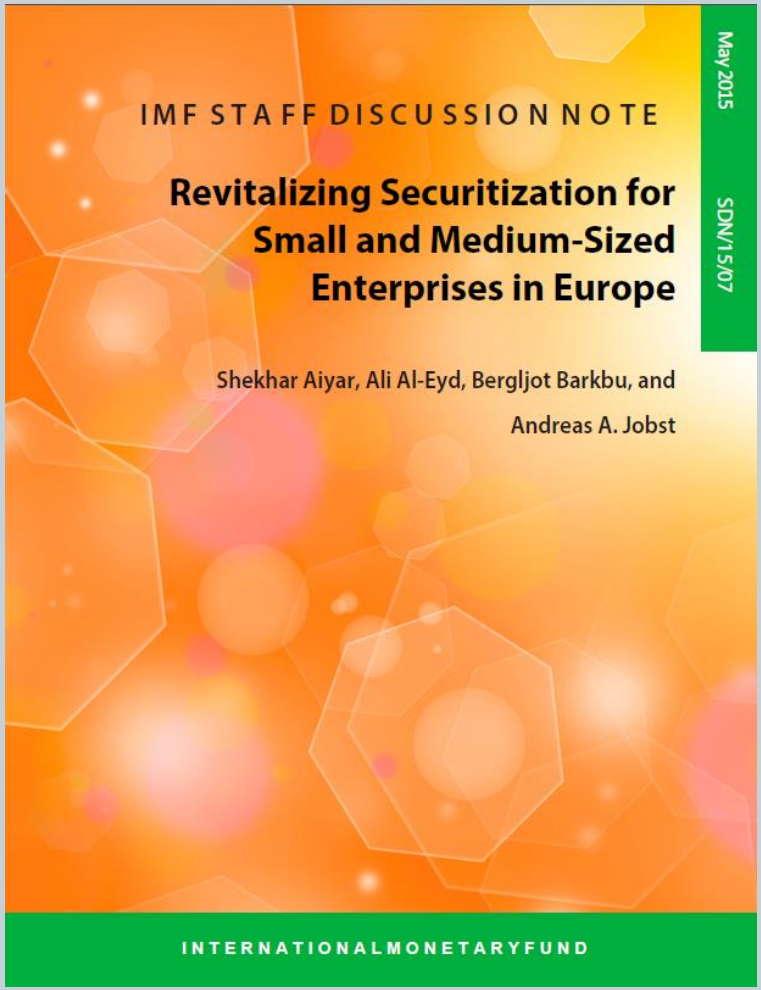

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- Available at http://www.imf.org/external/pubs/cat/longres.aspx?sk=42859.
- Blog: http://blog-imfdirect.imf.org/2015/05/07/securitization-restore-credit-flow-to-revive-europes-small-businesses/

Securitization can support **comprehensive strategy** to revitalize growth …

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- **Bank balance sheet repair and corporate de-leveraging**
  - Securitization supports cleanup of NPLs by providing capital relief, creating space for new lending
- **Capital market integration** to enhance the currency union
  - Securitization as alternative long-term funding for SMEs (even if "only" indirectly) → financial sector resilience, cross-border investment, euro area re-balancing
- **Supporting demand through** continued monetary accommodation
  - Securitization as part of the initial phase of QE (ABSPP)

European SMEs depend heavily on bank funding.

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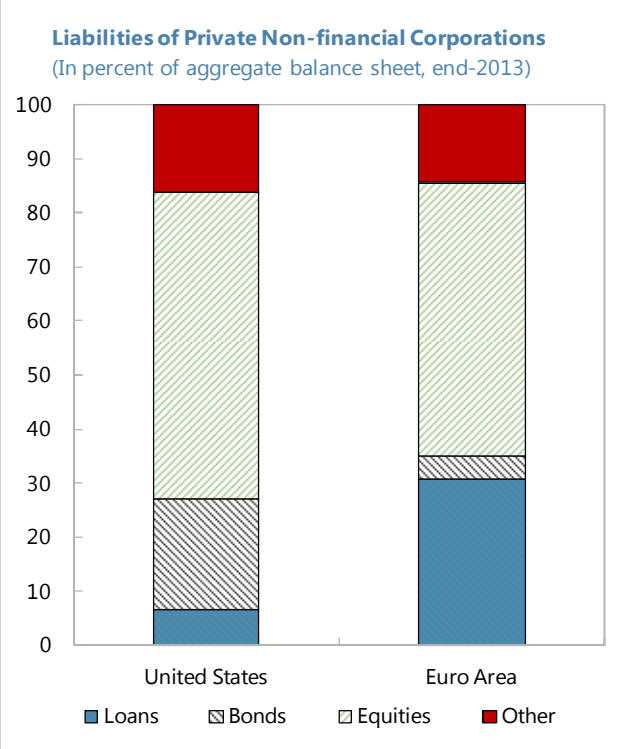
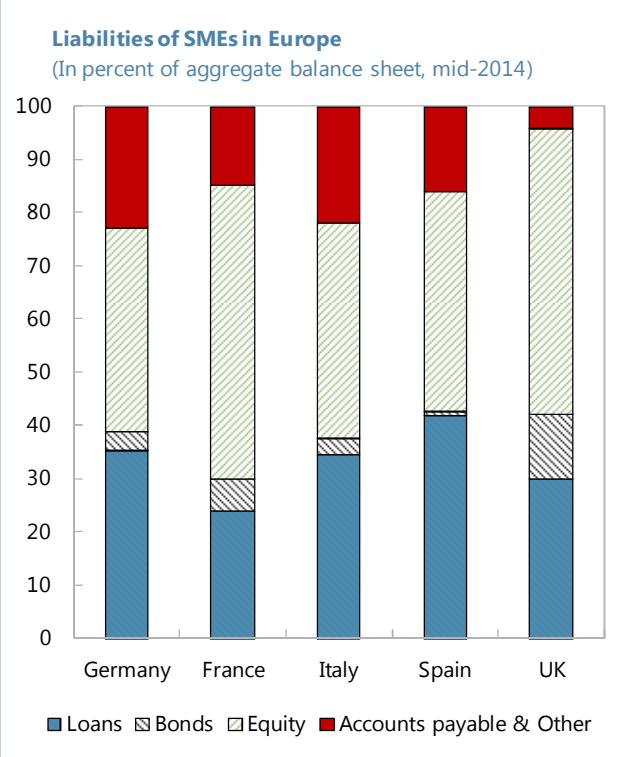
External finance of the corporate sector is **heavily dependent on bank lending.**



Source: Flow of funds from Bank of Japan, Federal Reserve, and ECB; Federal Reserve, Bank of England, ECB, and Bank of Japan. Note: Europe is the sum of the euro area and the United Kingdom. Data in right panel are end-Q3 2013, apart from Japan which are end-2012.

Most SMEs have **limited access to alternative, non-bank funding sources.**



Source: ECB and IMF staff calculations.

***Real* interest rates on SME loans remain high** in stressed economies amid negative credit growth.

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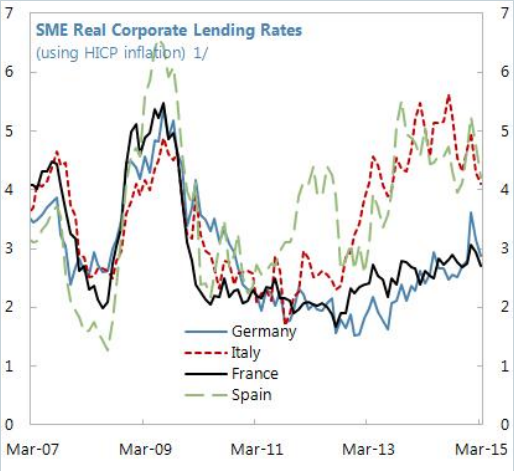
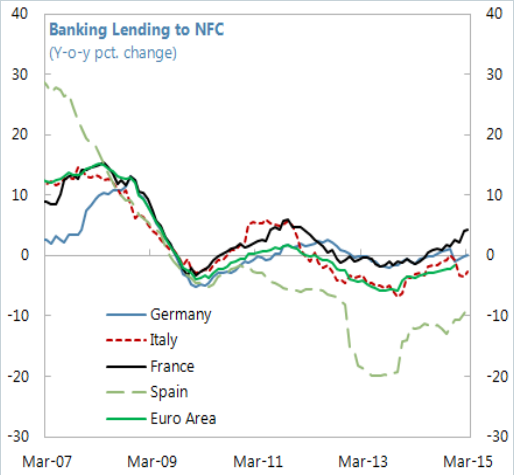
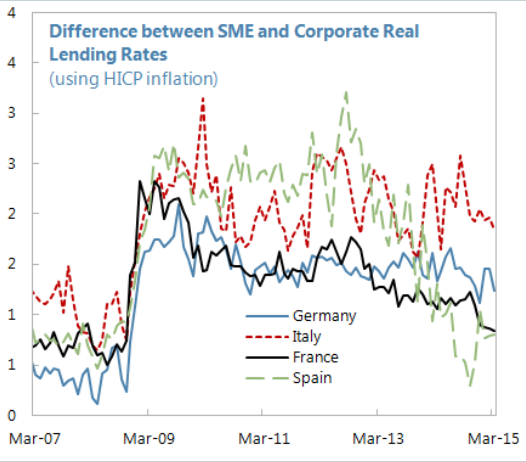
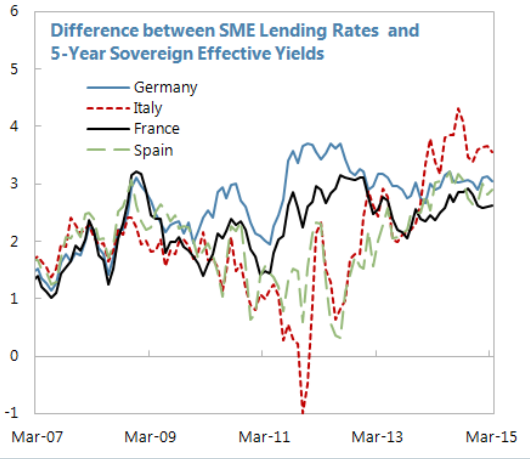




Sources: ECB, Eurostat, Haver Analytics, and IMF staff calculations.





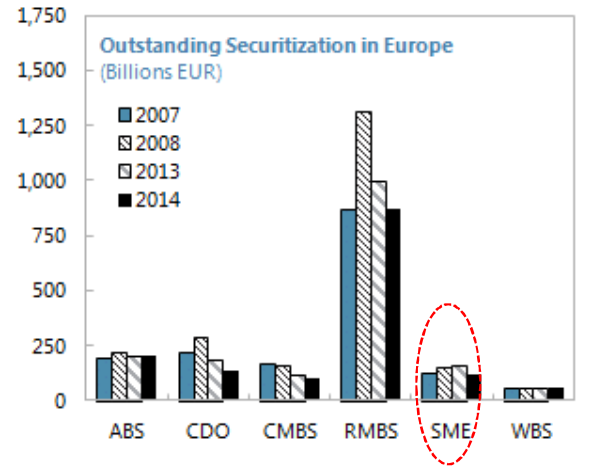
Sources: ECB, Eurostat, Haver Analytics, and IMF staff calculations. Notes 1/ MFI lending to corporations under €1 million, for 1-5 years. Real rates are calculated *ex post* using realized HICP inflation by country.

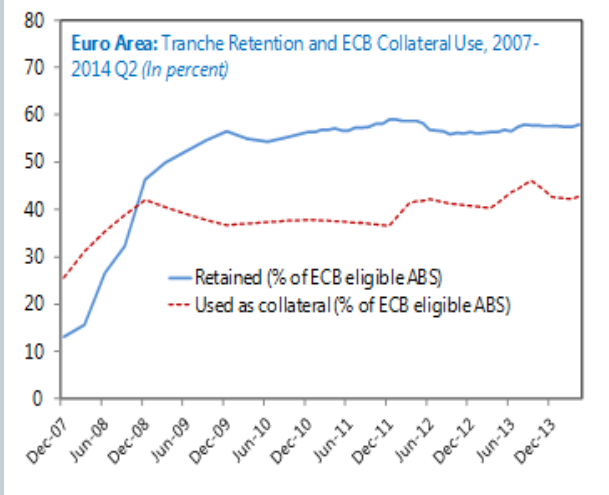
Turning maligned securitization into a force for good could yield **quick wins** and **lasting gains**.

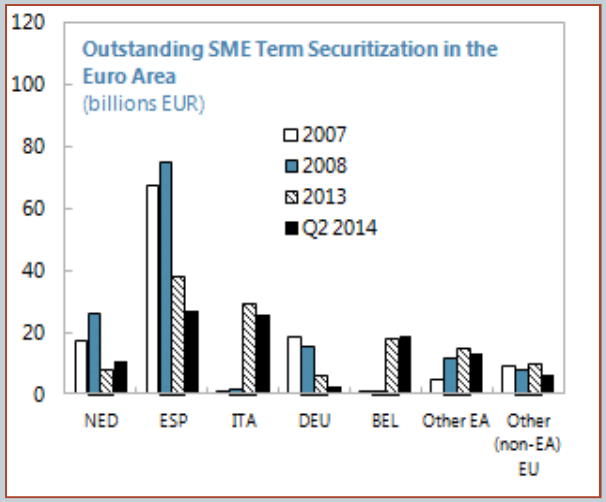
- **Enhances credit supply to SMEs**
  - Risk transfer from banks to new (non-bank) investors to fund SMEs (also via the indirect effect of non-SME transactions)
  - Market-based, alternative long-term finance via *direct securitization*
- **Strengthens financial sector resilience**
  - Diversifies bank funding at longer maturities (and helps weaker banks)
  - Improves allocation of savings to investment and cross-border investment → facilitates rebalancing
  - Effective diversification of risks within the euro area

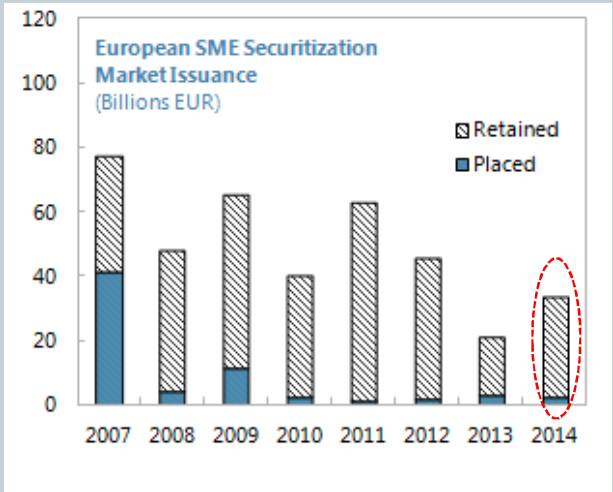
    → lower probability of local shock
- **Enhances monetary transmission**
  - Strengthens "credit channel" as banks become more responsive to market interest rates

The SME securitization market is **small** and **concentrated**, with almost all SME ABS being "**retained**"…

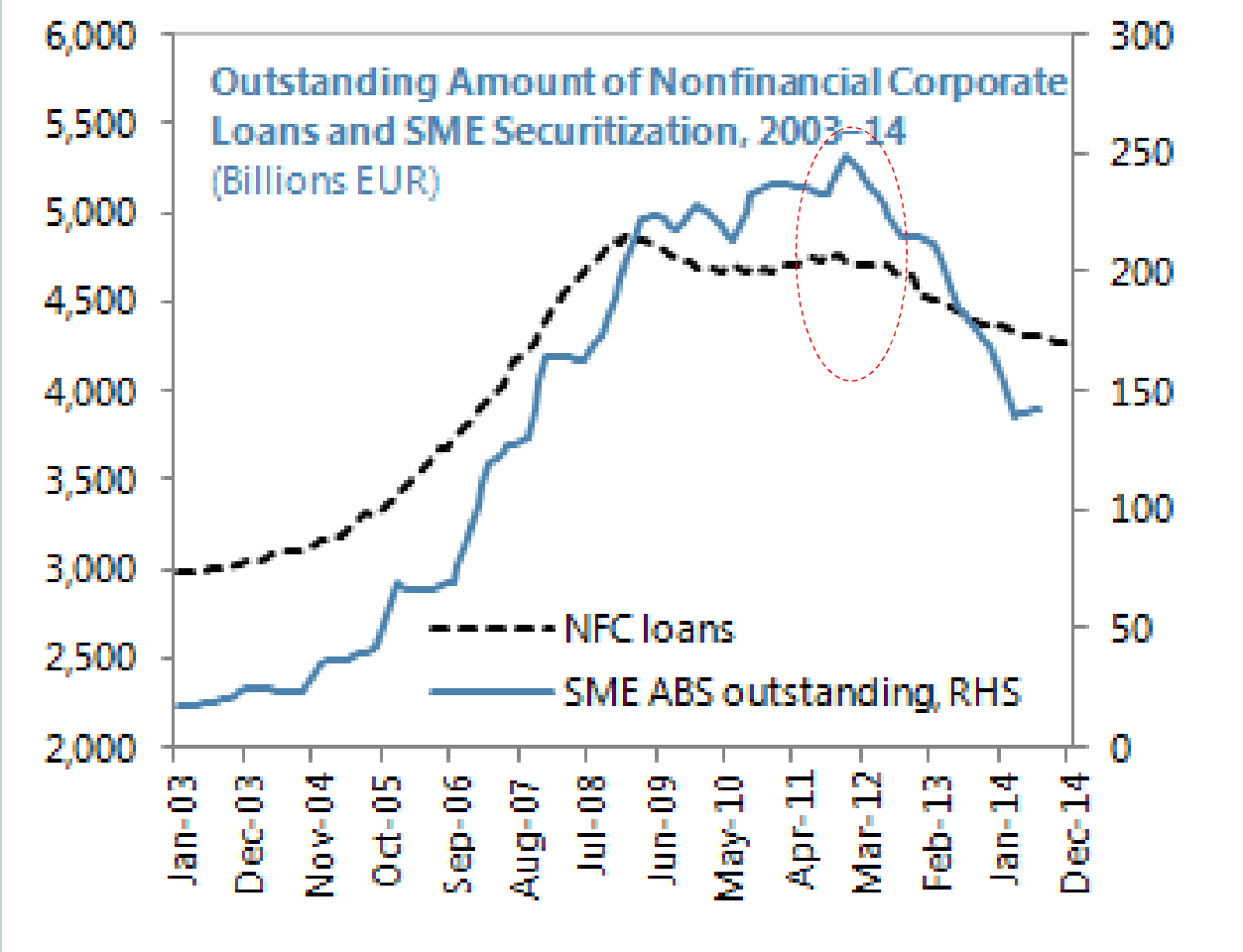








… and has **contracted even more than credit supply**.



The European SME ABS market proved to **very resilient** during the financial crisis, and **delinquencies have been decreasing** since 2012.

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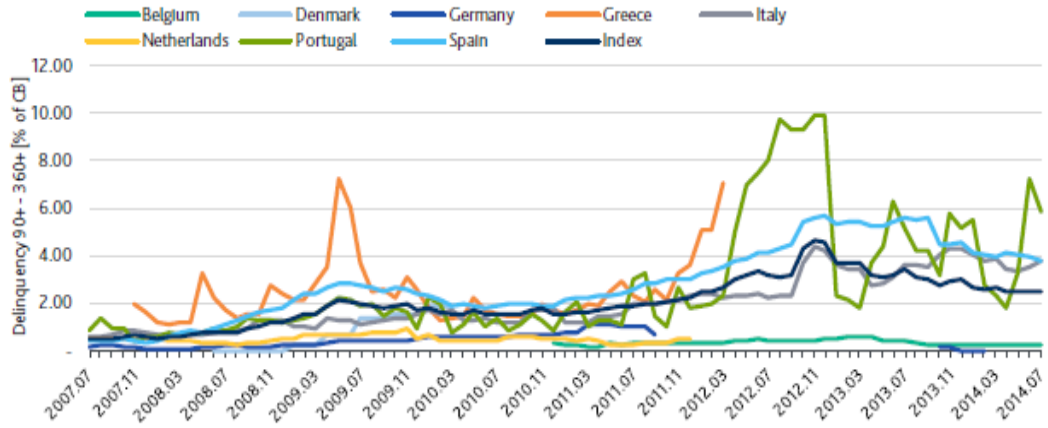
Few highly rated SME ABS became impaired between 2007 and 2014

SME

Rtg Cat. \ Horizon	Avg. Counts	1 Yr	2 Yr	3 Yr	4 Yr	5 Yr
Aaa	175	0.00%	0.00%	0.00%	0.00%	0.00%
Aa	75	0.00%	0.00%	0.00%	0.00%	0.00%
A	115	0.14%	0.35%	0.53%	0.53%	0.53%
Baa	93	0.70%	1.56%	2.14%	2.60%	3.77%
Ba	58	0.54%	1.25%	1.53%	1.53%	1.91%
B	31	0.53%	1.33%	1.81%	1.81%	1.81%
Caa	24	2.18%	5.12%	8.91%	13.68%	20.72%
Ca_C	16	13.04%	24.44%	32.87%	36.19%	39.79%

Source: Moody's Investors Service; January 2007 to March 2014.

The index of delinquencies over 90 days has steadily decreased since 2012



Source: Moody's Investors Service, periodic investor/servicer reports

There are several **distinct but complementary strategies** for revitalizing SME securitization …

- Our proposal builds on past/current EU-wide regulatory reforms (e.g., min. retention requirement, loan-level data, transparency/disclosure)
- **Recognizing high quality** (e.g., regulatory differentiation and more consistent treatment)
- **Infrastructure development** (e.g., credit registries, tax regimes, national debt enforcement laws/insolvency)
- **Targeted official sector support** (e.g., EU initiatives, nuanced ECB collateral treatment)
- Actions can be mutually self-reinforcing (if implemented together)

Establish greater **regulatory differentiation** of securitization products …

- ***Differentiated* regulation *within* securitization market** for high-quality securitization (HQS)
  - Clear criteria to identify simple, transparent and prudent asset structures
  - More lenient regulatory treatment at any level of risk
- ***Equitable* regulation *across* all forms of structured finance**
  - Capital and liquidity risk requirements + investment restrictions
- **HQS should *complement* (rather than substitute) current regulatory standards**
  - Recognize different degrees of risk *within* HQS to prevent investor complacency from regulatory endorsement
  - Refine risk-sensitivity of *Securitization Framework*, irrespective of HQS

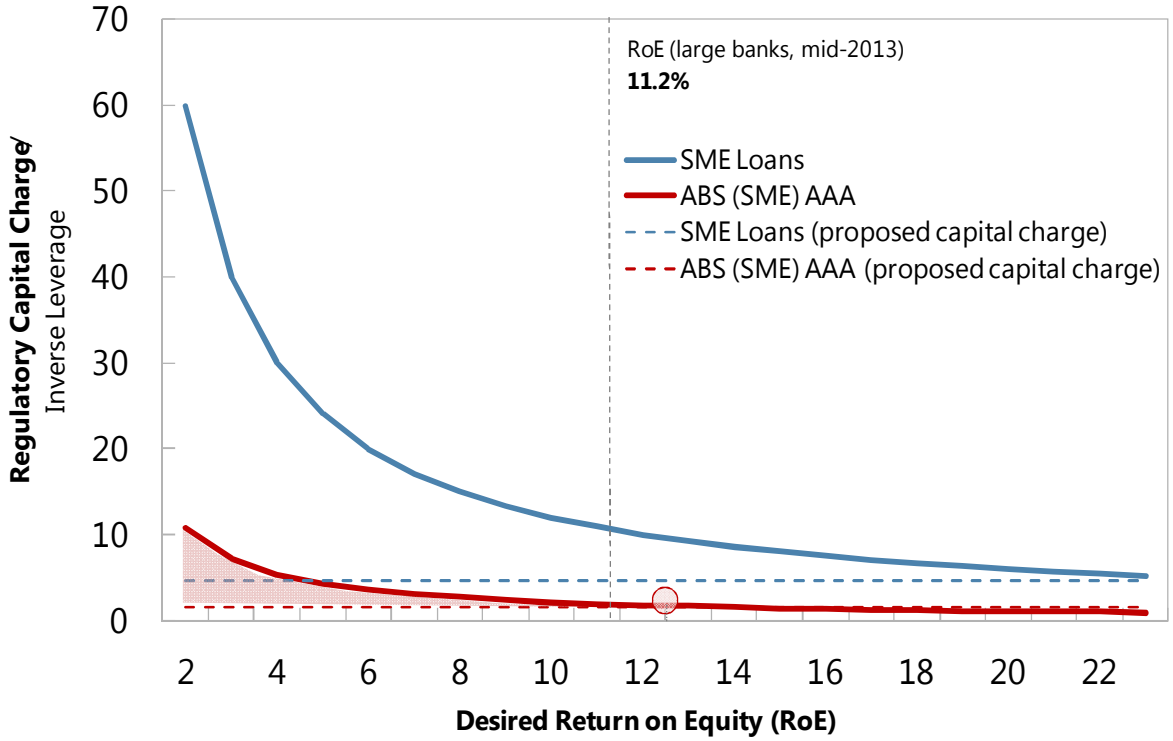
Attributes of High-quality Securitization (HQS): General Criteria

- **Asset characteristics**
  - Sound underwriting practices (risk governance, no selection bias, prohibition of self-certification)
  - Funding for real economic activity and no re-securitization
  - Asset eligibility (business-relevant, performing, and no general restriction on underlying exposure)
- **Structural features**
  - Asset/risk transfer without market risk (or other unrelated risks)
  - Risk retention (no exemption)
  - Payment process (self-liquidating portfolio, clear payment structure, no circularity of support)
  - Servicing/counterparty continuity and investor rights/collateral access
- **Comprehensive documentation and reporting requirements**
  - Scope of disclosure (asset quality/transaction performance)
  - Structural integrity and quality (rating and subordination requirements → min. credit quality but no limitation to senior tranche only, portfolio assessment)
  - Listing and trading requirement

Regulatory treatment for banks makes securitization unattractive compared to SME loans …

Europe: Market-implied Regulatory Capital Charge for *Banks* at Current Yields for Different Levels of Return on Equity

(as of end-Dec. 2014, In percent)

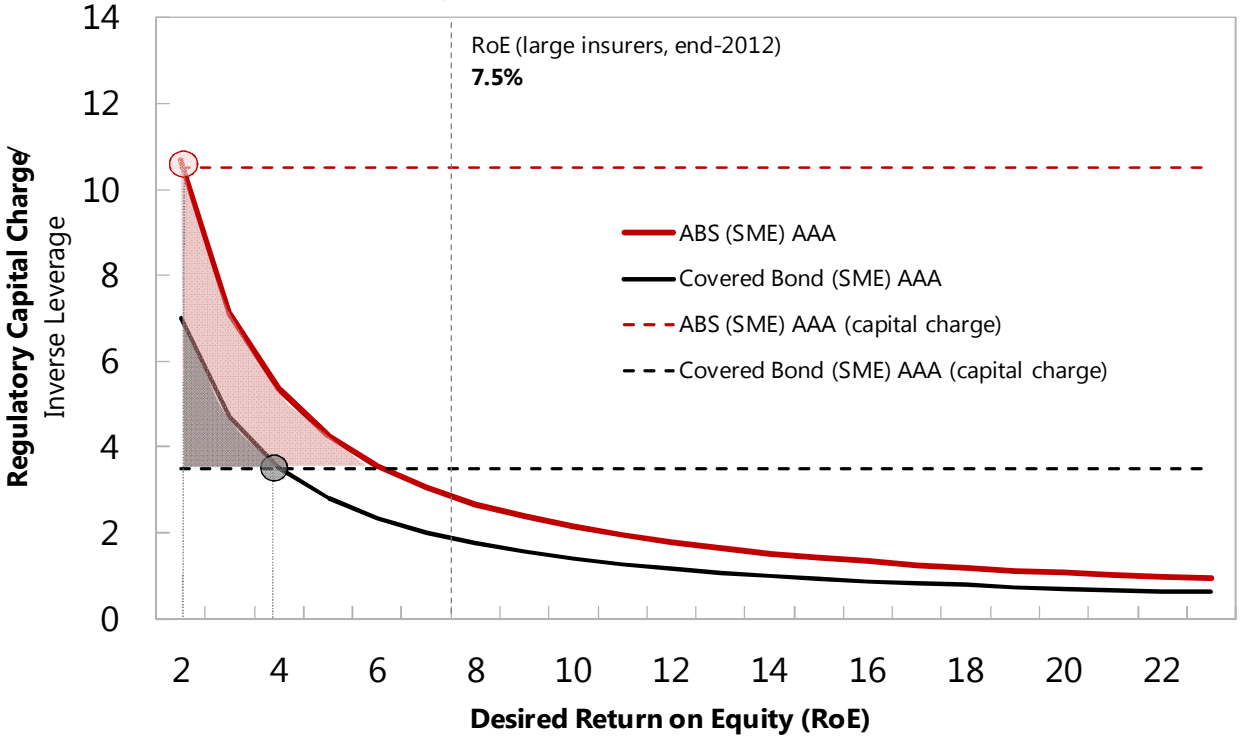


Sources: BCBS, EBA, Bloomberg LP, and author's calculations.

… and **even more so for insurers.**

Europe: Market-implied Regulatory Capital Charge for *Insurers* at Current Yields for Different Levels of Return on Equity

(as of end-Dec. 2014, In percent)



Sources: EIOPA, Bloomberg LP, and author's calculations.

Infrastructure Development

- **Encourage *direct* (non-bank intermediated) securitization**
  - EC's *Communication on Long-term Financing of the European Economy* (2014), e.g., mutual issuance platform, trade receivables via ABCP facilities, and private equity
- **Harmonize debt enforcement regimes** to protect secured claims and support cross-border investment
  - Lengthy and costly foreclosure (cost of debt workout, plurality of creditors)
- **Address heterogeneous SME lending and credit information**
  - Develop pan-European reporting requirements based on ECB's loan-level data on SME ABS/EIB lending standards and credit registries
  - Leverage on data collection by *European Datawarehouse* (EDW) to include non-securitized loans (for pricing and benchmarking)
  - SME loans in dual recourse instruments → *European Secured Note* (ESN)

Official Sector Support (1): Existing Initiatives and Funding

- **Reconcile and integrate existing European initiatives** to exploit operational synergies and increase scale
  - COSME Securitization Window, EIB Group ABS Initiative, and EC-EIB SME Loan Initiative
- **Further enhance capacity of EIB/EIF** to facilitate genuine risk sharing as confidence in HQS grows over time
  - Guarantors (→ lower cost of subordination due to higher marketability) or strategic investors (→ lower amount of subordination due to higher pricing) to encourage efficient structures
  - Important signaling effect to investors and enhanced secondary market liquidity for guaranteed tranches

Official Sector Support (2): Eurosystem Collateral Framework

- **Nuanced treatment to encourage HQS and *efficient* asset structures** (→ credit risk transfer)
  - **HQS requirement** (as per IMF proposal): senior tranches of highest rating and *rated* structural subordination
  - **Additional requirements**
    - Tranches only eligible if entire asset structure is HQS-compliant
    - Third-party distribution of tranches greater than retention
    - Comprehensive disclosure of asset quality of securitized and non-securitized assets and transaction performance
- **Differentiate valuation haircut *categories***
  - Flexibility in setting haircuts (rather than broad IG/non-IG distinction) using data on (non-)securitized SME loans from loan-level data under ECB disclosure requirements
  - More consistency across different instruments (e.g., ABS vs. covered bonds)

Conclusion

- **Further development requires** …
  - Greater regulatory harmonization and differentiation HQS transactions
  - Structural reforms for "attractive SME finance" (harmonized credit registries, effective insolvency frameworks, and consistent reporting standards)
  - Targeted official sector support (ECB collateral framework and enhanced capacity of European development institutions)