

Conditions for revitalising securitisation based on Prime High Quality Securitisations (PHQS) of SME loans



This document was drafted by Eurofi with input from its members. It does not engage in any way the Italian EU Council Presidency or the Italian Financial Authorities.

1. Context

Tougher financial regulation has made European banks more resilient, but the adjustments to this strengthened regulatory framework and the balance-sheet repair still ongoing in many parts of the European banking sector are hampering the capacity of banks to lend. The insufficient credit, which is now confronting even sound businesses in some parts of Europe is making the continent's economy more fragile and weighs on its recovery.

Improving the profitability of EU banks is not feasible in the short term. Thus, fresh investment capital is not easily available for banks. Therefore, stringent liquidity and capital adequacy ratios can be met only through a reduction in assets, including loans. Fixing the problem of the rationing of credit is an urgent task given the present sluggish recovery conditions.

One avenue is for companies to gain direct access to financial markets through equity or bond instruments. But this is not an option for smaller companies.

An appropriate answer for such companies is to revitalize the market for securitized loans, in order to support bank lending. However this market, which never really took off in Europe before the crisis, has all but vanished since the financial crisis.

Before this can happen, confidence needs to be rebuilt and the memories of opaque subprime securitisation structured in the US before the crisis must be dispelled by adequate measures. This requires that both the quality of underlying bank loans and the securitisation techniques be beyond question.

Eurofi is therefore proposing to develop a Prime High Quality Securitisation (PHQS) asset class with a specific label in order to encourage SME lending.

In addition a recalibration of bank and insurance company regulations, factoring in the true risk of PHQS, is necessary to enable them to invest in such products. Finally in certain E.U. countries it is also necessary to address possible issues regarding the returns of SME loans, which may threaten the economic attractiveness of related securitisations for investors.

Such a project offers a way forward to repeated calls by the European Central Bank, for loans to small and medium-sized enterprises (SME) to be repackaged into standardized products that are easy to assess and rate and simple for investors to price.

2. Revitalizing the SME loan securitisation market requires to issue in priority securitized products underpinned by a high quality securitisation process and prime underlying assets

In the perspective of revitalising SME securitisation the challenge is to stabilise at the E.U. level a common set of simple and sufficient criteria, in order to define Prime High Quality Securitisation (PHQS).

Securitisation process

Everybody admits at present that a high quality securitisation process is necessary to guarantee that securitized products are transparent, predictable and raise no conflict of interest among the various participants in the value chain (i.e. originator, rating agency, structurer, servicer and buyers).

Providing investors with sufficient transparency is also necessary, so that they can comply with their internal and external disclosure requirements.

We agree with EIOPA that a distinction between securitized products categories is necessary to reinforce confidence in securitisation. EIOPA has indeed proposed a set of criteria defining a specific category of High Quality Securitisation (HQS) - the A category - in the perspective of the Solvency II delegated acts due to be proposed by the E.U. Commission. The European Central bank has also defined certain conditions to improve the transparency of those securities, as a condition for their eligibility (loan by loan information, data base...). These are critical steps forward in the right direction.

To make the securitisation process sufficiently reliable, Eurofi however proposes to complement these criteria in certain key areas. We believe in particular that the simplicity of the approaches for tranching is critical (true transparency and predictability) and would therefore suggest limiting the HQS label to securitisation with 3 levels of seniority as a maximum (Equity, Mezzanine and Senior).

We consider that there is also a need to increase the requirements related to the data involved in the risk assessment and the tranching of the securitisation (e.g. data covering both SMEs and SME loan performance in general and data relative to the securitized assets), which in particular should include sufficient long series encompassing stressed periods.

Lastly we consider that the most appropriate way to reduce the conflict of interest on the side of the originator is to go beyond the usual “skin in the game” rule and to impose a vertical retention rule obliging originating banks to retain a portion of each tranche.

High quality underlying assets

In addition, restoring the confidence of investors in securitisation requires securitizing underlying assets of unquestionable quality. Indeed, an appropriate - simple and transparent - structuring of the securitized product is not sufficient to eliminate the risks of the underlying loans.

We propose focusing within the asset classes selected by EIOPA, on assets, which remain sound even in the event of a deteriorating economic context and are less exposed to bubbles or economic cycles.

This is the reason why we propose to start the efforts to relaunch securitisation with bank loans to “prime” SMEs. We can also envisage extending the list of these prime assets for example towards consumer or auto credits whenever objective data exist (e.g. positive consumer credit databases) but also to mortgages provided that central banks consider such mortgages are not exposed to real estate bubbles.

Prime SMEs would be defined as enterprises with a 3-year probability of default lower than 0.4%. This is more demanding than the one used by the Eurosystem to accept SME loans as eligible collateral (1-year probability of default less than 0.4%) in order to effectively reassure the buyers of those securities including potentially the ECB.

According to the Banque de France, which rates SMEs, the number of SMEs which have a 3 year probability of default lower than 0.4% encompasses in France around 40.000 SMEs and represents €150 billions' worth of loans, which is quite a significant segment of the market.

Moreover, we propose that this “prime” label be attributed by, or under the supervision of, neutral institutions such as central banks or supervisors rather than by originating banks or rating agencies. The ECB accepts 3 methods for assessing the quality of collateral: first the rating by central banks - certain EU central banks rate SMEs -, next the rating by a rating agency and lastly the outcome of the internal models used by banks as far as this outcome is validated by the banks' supervisors and follows a commonly agreed methodology.

In a context where the Single Supervisory Mechanism (SSM) is expected to rapidly reduce existing discrepancies between modelling approaches (RWA) run by the banks of the Eurozone and between supervisors' validation practices, and given that at the E.U. level the EBA has undertaken² a critical task to improve the confidence on the validation process of internal models by supervisors, using internal models should be acceptable for investors and market participants.

In summary, combining the criteria imposed on the securitisation process and on the underlying assets is the way to define a “Prime High Quality Securitisation” (PHQS) that should be the bedrock for a revitalized SME loans securitisation market.

This requires however that the financial regulation as a whole - bank and insurance prudential requirements in particular - fully factors in the low level of risk of such a Prime High Quality Securitisation asset class. It is not asking for a SME privilege but for an equal treatment with other securities bearing the same risk.

Regulators today do not dispose of historical market data that could be relevant for such PHQS instruments of the nature we would like to propose. Indeed until now, the criteria defining HQS were not explicitly used in financial markets as an investment factor to trade securitized products and securitisation issues did not focus at that time on prime assets.

Consequently, regulators have to devise a dedicated methodology to calibrate regulatory capital charges, based on a relevant projection of the risk and liquidity of such brand new assets.

3. Addressing possible issues regarding insufficient returns of certain E.U. SME loan securitisations.

To attract investors, products need to generate sufficient returns. Depending on market conditions, insufficient mark-up by banks on SME loans might affect the economic attractiveness of securitisation products compared to other possible investments. This would be the case for example, whenever SME loan portfolios yield 150 bp (prime SME loans) on average to originating banks while markets demand 200 bp for similar risks. Indeed competition conditions and commercial practices (cross-subsidies) in certain

² Third interim report on the consistency of risk-weighted assets - EBA - 17 December 2013.
EBA has in particular targeted to improve the definition of defaults, to harmonise at the E.U. level data sources, the length of the time series and the approaches used for calibrating the models predicting the probability of default. In particular the EBA is addressing the issue of the possible absence of available time series of stressed conditions. In parallel the EBA is encouraging more rigorous and comprehensive model validation processes and back testing frameworks, and is promoting the exchange of experiences on the validation and ongoing monitoring of internal models notably through joint work in colleges.

countries, may lead banks to apply reduced marks-up on SME loans.

However, this situation is expected to improve. Increased costs imposed by regulations on banks are likely to increase lending prices over time. In addition, in certain EU countries, average market yields have been reduced significantly due to the “flight to quality”. This reduces the gap between the anticipated yield of SME securitisation and the yield of alternative investments presenting similar risks. Moreover investors should be attracted to this new asset class for the diversification effects it can offer.

Mapping possible situations in the E.U. where loan yields may be insufficient to attract investors to securitisation products is necessary.

In the case of a country in the Eurozone where existing loan yields are insufficient, one possibility to facilitate the securitisation of prime SME loans would be that organizations like the European Investment Bank or national development banks should provide a form of guaranty, though very limited, on the first thin layer of losses. This should help investors to accept a lower yield than the actual average mark-up of the portfolio until the market picks up.

In addition the fact that the European Central Bank would be there to buy, not only to accept as collateral, but to buy some quantum of these PHQS at least for a certain period of time, would give confidence to the market and reduce yield demands.

4. Calibrating capital requirements for insurers building on the proposals of EIOPA

Launching Prime High Quality Securitisations (PHQS) as defined in paragraph 2 entails appropriate capital charges for insurers in order to make the business case of such investments sufficiently attractive.

Although EIOPA recommended in December 2013 decreasing the charges for less risky issues to 4.30% (type A) while increasing them for riskier ones to 12.50%, and even if those calibrations were further divided by 2 as envisaged by the EU Commission, insurance companies observe that such capital charges are significantly higher than those required to hold directly loans of similar quality and therefore still consider that their ROI will be negative with such calibrations.

Therefore a major issue to revitalize the SME loan securitisation market, besides the definition of the relevant criteria for defining a PHQS, is to achieve a calibration of capital requirements for insurers, taking into account the real risks of such products.

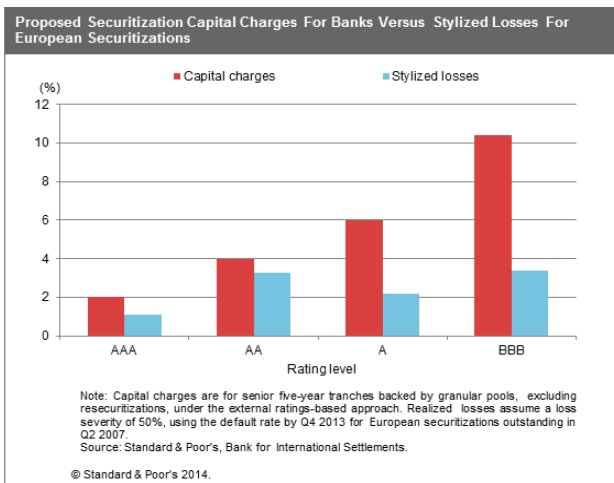
The risks of the underlying assets that are well known and can be easily reflected in the calibration represent a sufficient basis to define such capital requirements for insurers. Indeed, though we share EIOPA’s views that the specificity of the risk profile of a securitisation is that it combines the risk of the underlying assets, with the risk specific to securitisation techniques - e.g. information asymmetries, legal risks, conflicts of interest, servicing risk, etc. -, we are of the opinion that whenever the securitisation process effectively uses criteria such as those mentioned in paragraph 2 (vertical tranching, availability of appropriate data...) in particular in the case of assets of unquestionable quality, the risks specific to securitisation techniques are actually sufficiently mitigated.

5. Banking capital requirements for securitisation tranches also need to be reviewed

The Basel Committee has introduced a risk sensitive approach for the calibration of investments by banks in securitisation products. But this Committee has also proposed setting a 15% risk-weight floor for all approaches. Consequently, according to many observers, the proposed risk weights resulting from this approach are still far from being consistent with the credit performance of securitisations (see table below).

In particular, the high level of the floor proposed will overwhelm the risk sensitiveness of the framework up to the point that such a floor becomes a binding constraint. This should discourage banks from securitising or holding securitisation tranches. Indeed this floor (15% risk-weight) would impose capital charges 7.5 times higher to a bank holding a AAA credit exposure through a securitisation vehicle, than the charges requested (2%)³ when it holds it directly.

In addition SGP based on very prudent loss assumptions, estimates that AAA securitisation tranches would receive a risk weight the double of their expected losses⁴ (see table below).



Addressing this issue is important because banks would be submitted to such excessive capital charges for the mandatory retentions of the securitisations they originate.

Another issue is the proposals made by the European Banking Authority (EBA) in the context of the delegated acts for enforcing the LCR, which only consider a limited number of RMBS as Liquid Assets (these RMBS do not include SME securitized loans even if they are of high quality), and require excessive haircuts.

This would deter banks from investing in these prime high quality securities (PHQS), as they would be considered as poor liquidity financial assets. This would be in contradiction with the ECB aim to possibly buy outright such financial assets.

The inappropriate calibration of these proposed measures is due to the fact that Basel and the EBA have not at this stage distinguished between PHQS and the securitisations of lesser quality in the same way as what has been previously mentioned for insurance calibration, and that existing data on the historic performance of ABS does not reflect the risk specificities of PHQS because this category has never been observed.

To achieve a more appropriate regulatory calibration - required for reviving the securitisation market - the Basel committee as well as the European Commission /EBA should therefore consider PHQS as specific products, in particular more reliable and predictable due to the new criteria proposed, and consider them as a new asset class.

³ According to default data produced by Fitch in its document "1990-2013 cumulative default rates", the ten year probability of default of such a AAA credit exposure is 0; therefore a notional 2% risk weight is applied.

⁴ For calculating "stylised" losses S&P assumes a loss severity of 50% and applies the default rates observed in Q4 2013. According to the ECB, European ABSs' defaults range since the start of the 2007/08 financial crisis, between 0.6-1.5% on average. In addition the Central Bank states that European SME ABSs are far below broader EU securitisation default rates, with defaults occurring on about 0.1% of instruments.