

Asset Backed Securities:

A Better Solution for Europe

Action Institute

19 January 2015

Action Institute is an independent, bipartisan and non-profit "Action Tank". It was born as a civic response to address the urgency of the current economic and social crisis that has hit Italy since 2008. Action Institute is composed of a group of distinguished professionals who excel in their field of activity, who work on a purely personal and pro bono manner, in order to develop actionable and high-impact proposals to boost the competitiveness of Italy. Action Institute wants to aggregate people of recognized integrity and proven merit, motivated by a strong civic commitment and coming from a broad and diverse set of backgrounds: industry, finance, entrepreneurship, legal, innovation, consulting, academia, government, judiciary, art and culture, science and media.

Action Institute è un "Action Tank" indipendente ed apolitico che vuole catalizzare le migliori energie intellettuali del Paese in un impegno civico a beneficio delle Istituzioni e della Società. Action Institute è costituito da un gruppo di professionisti che si sono distinti nel proprio campo di appartenenza e che lavorano a titolo puramente personale e pro bono per fare proposte attuali, pratiche e d'impatto che permettano di rilanciare la competitività del Sistema Italia. Action Institute vuole aggregare persone di massima integrità e motivate da una forte passione civica provenienti dal mondo delle professioni, dell'industria, della finanza, dell'imprenditoria, della consulenza, dell'accademia, della pubblica amministrazione, della magistratura, della cultura, della scienza e dei media.

Asset Backed Securities:

A Better Solution for Europe

EXECUTIVE SUMMARY

Credit is vital to Eurozone firms. SMEs create 80% new jobs and fund 80-90% through bank loans. But banks are not lending: they cut over €600bn of loans to non-financial firms since the crisis, 12% of the initial stock and twice the size of the European high yield bond market. The credit crunch is worst in the periphery, where over a fifth of firms say lack of credit is their main problem. Even after the ECB stress test, many banks in the Euro area remain weak and focused on rebuilding capital, also in light of more upcoming regulation. Despite more ECB action pushing bond yields down, credit is still not getting to the real economy. Investors are sceptical: 51% believe sovereign bond QE will work only in financial markets, while 25% believe it will not work at all.

To fix the credit crunch, lowering yields is not enough – Europe needs an instrument linking markets to the economy. Asset backed securities (ABS), together with other instruments (mini-bonds, crowdfunding), can provide this missing link for stimulus to reach out to small firms. The market for asset-backed securities is now supported by the ECB purchase programme (ABSPP), but remains segmented and lacking standardisation, with many regulatory hurdles hindering its potential growth. The ECB has so far bought €788mn of ABS, a tiny fraction of the €1.4tn market. In this paper, we analyse the economics of ABS and discuss the potential policy measures which could unlock the development of “simple, transparent and real” asset backed securities. We believe that ABS could help plug the eurozone’s credit gap, particularly concentrated in bank-centred periphery economies, where loans represent up to 95% of credit. The creation of a “simple, transparent and real” ABS instrument would also make sovereign QE more effective through the portfolio rebalancing channel, giving investors a new asset class to buy, as a substitute of sovereigns and covered bonds. Finally, transitioning from a bank-centred to a more market-based credit supply would make Europe’s financial system more resilient to future shocks and less vulnerable to banks, which are still three times larger than GDP, among the largest in the world.

KEY CONCLUSIONS

To be effective, the ECB ABS plan needs a combination of regulatory and fiscal support: simple and harmonised rules, lower risk weights and government guarantees.

Reviving the ABS market is a critical step to enable lending to start again in Europe. *ECB ABS purchases have been viewed by many as a "failure" before their start, given the intrinsic difficulty in achieving a large-scale purchases. Instead, we believe the plan could bring long term structural benefits to Europe's credit markets. If successful, reforming ABS could diversify credit supply and lower funding costs for European businesses. The main hurdles, however, are strong segmentation in the market, lack of clear rules for banks to issue ABS with the benefit of risk-transfer and de-consolidation from their balance sheets, and lack (so far) of sovereign support to the programme launched by the ECB, which will only be able to buy senior tranches or mezzanine tranches with a guarantee.*

We calculate the economics of ABS purchases and guarantees, and the potential benefits to SMEs could be substantial. *The average interest rate on a loan to an Italian or Spanish SME is around 4.5%. Lowering the yield on a mezzanine ABS tranche (10-30% of the capital structure) by 2pp could lower the interest rate on the SME loan by about 40bp, saving it around 10% on its interest costs. Assuming the SME is 5x leveraged, as over one third in Italy and Spain, this would raise its free cash flows by around 10%.*

In addition, a revived ABS market with sovereign guarantees could even make sovereign QE more effective, through portfolio rebalancing from sovereigns to a new quasi-sovereign asset class linked to loans and SMEs.

In this report we discuss some key measures that could help revive the ABS market:

1) Lower capital charges on simple ABS. *These would help expand the investor base, particularly to insurers, which hold less than 5% of placed securitisations. The EC has slightly lowered Solvency II capital charges and allowed banks to include more ABS in their liquidity buffers. But capital charges still make ABS unattractive next to similarly-rated corporate bonds, or sovereigns, which mostly still carry 0% risk weights. There is some tentative progress on this point: the Basel committee, while maintaining high capital charges, proposed criteria for the*

creation of simple ABS structures recently, which may benefit from lower capital charges in future.

2) Standardisation and harmonisation of rules. These would help banks get the “significant risk transfer” (SRT) necessary to deconsolidate the securitisation from their balance sheets, i.e. allowing them to lend with less capital. The ABS market would also benefit from harmonisation of loan markets and bankruptcy regimes.

3) Fiscal support for guarantees of mezzanine tranches. The ECB currently can buy senior tranches and mezzanine tranches only with guarantees. Combined with ECB purchases, mezzanine guarantees would help reduce yields on these tranches and make junior tranches more attractive to so-far reluctant investors, helping banks to sell the full capital structure of a securitisation (less a 5% retention requirement) and thus getting capital benefits. But governments so far remain reluctant: among large countries, only Italy has considered to guarantee mezzanine tranches, with Germany, France and Holland refusing. Ideally, European-level action by the European Investment Bank or the European Investment Fund, both institutions with extensive experience on ABS, should be welcome (potentially as part of the EU Juncker plan for investment) as apart of the and would be more effective than leaving each country to implement an individual approach.

Finally, we stress the point that ABS purchases and any measures to support the ECB plan, like guarantees of mezzanine tranches, should not be seen as a substitute for bank reform and consolidation. The European banking system is still widely inefficient, fragmented and overburdened by high costs, especially in countries like Italy, with around 780 banks and more bank branches per person than any other OECD country. Improving capital and profitability should remain key objectives, as highlighted by the ECB tests. Countries like Spain and Ireland, which consolidated their banks early in the crisis and created public bad banks, are now reaping the benefits through a recovery in lending. Italy instead has lagged on both fronts—but there are positive signs, like the recently-announced reform of the popolari banks.

Asset Backed Securities:

A Better Solution for Europe

CHAPTER 1. Fixing the transmission mechanism: Why ABS could work

Why asset-backed securities? The answer is simple: Europe needs an alternative to banks. Banks supply around 80% of credit in Europe vs around 20% in the US. However, banks continue to deleverage, having cut €3.7tn in assets and over €600bn in corporate loans (-12%) since the crisis. With 20% failing the ECB tests and another 24% passing by a narrow margin, we think they won't be able to grow lending any time soon. There are two key ways ABS could work. Firstly, they could channel central bank liquidity from financial markets to the real economy: bond yields are already low, but SME borrowing costs remain high. ECB support and public guarantees for ABS could make sovereign QE more effective, by attracting sovereign investors to ABS. Secondly, ABS could make banks smaller and the financial system more resilient to future shocks. European economies remain vulnerable – banks are over 3x GDP and could face losses of up to 15% of assets in another potential systemic crisis. The US experience has shown that a disintermediated financial system can more easily reset itself, with consumers and firms restructuring their debt in public markets, and governments able to recapitalize banks, which are smaller. In a systemic crisis, Europe's single resolution mechanism and bail-in tools remain illusory solutions, given the size of banks and lack of alternatives to credit supply (see also: [The Revolver | European banks: Still too big to fail](#)).

A [simple ABS structure](#) can help banks to transfer risk and share risk with investors. This would allow banks to improve their capital, leverage, liquidity and asset encumbrance ratios compared to funding with deposits or covered bonds. Banks would thus be more able to expand lending. Moreover, ABS yields should be more correlated with sovereign yields, allowing better transmission of ECB stimulus.

In a crisis, ABS can make a banking system more resilient: while the crisis started in the US in sub-prime ABS, the US banking system was/is smaller (90% GDP) and easier to recapitalise also because of securitisation. Most credit losses in the US were spread through bond markets. The result: US public sector debt grew to help the private sector, but *total debt decreased*, thanks to debt restructuring, reducing the balance sheet recession problem. In Europe, losses spread through the banking system, with a much longer workout period.

US financial markets have allowed net export of credit losses

The US financial system was able to export some losses to foreign investors through bond markets
 Cumulative losses on bonds and bank loans since the crisis, % GDP



Source: RBS Credit Strategy, Federal Reserve, ECB, Moody's

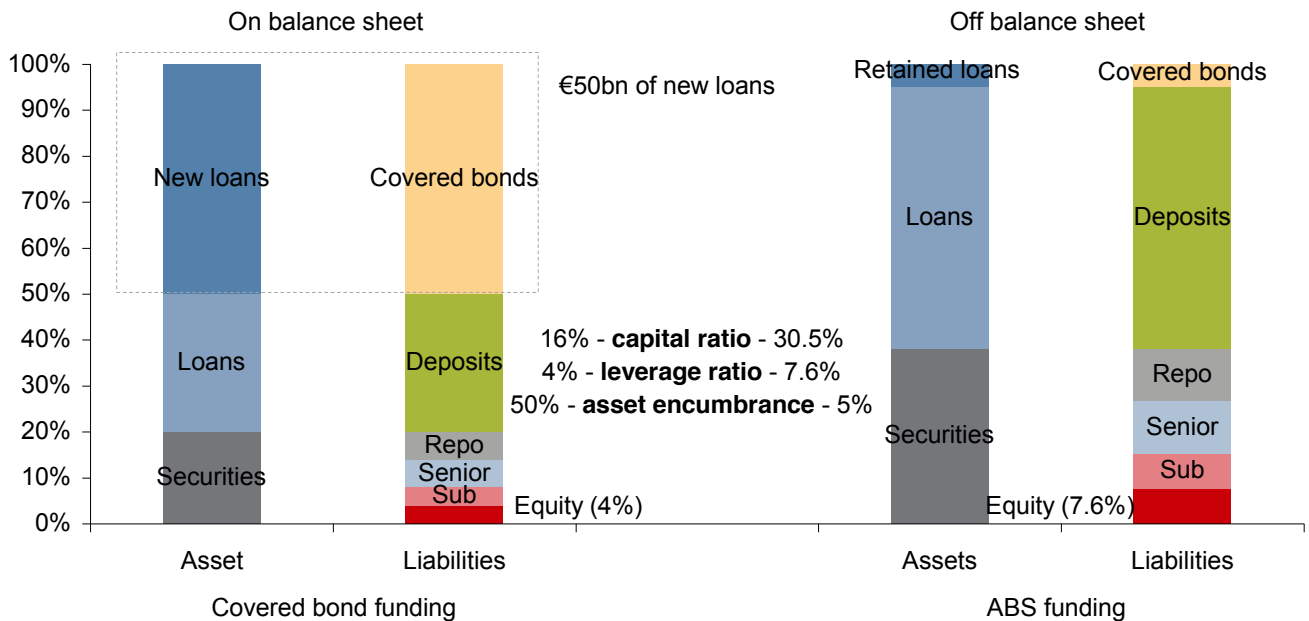
Source: RBS

Risk transfer and retention. For banks to deconsolidate a securitisation from their balance sheet – and hence to get the capital benefits from it – they need to demonstrate that a transaction involves a significant risk transfer (SRT) (see EBA [final guidelines](#)). In addition, to better align banks' interests with investors and prevent information asymmetries, originators need to retain at least 5% of the net economic interest in the securitisation. That means a bank needs to sell the full deal – less the 5% retention requirement – to get capital benefits.

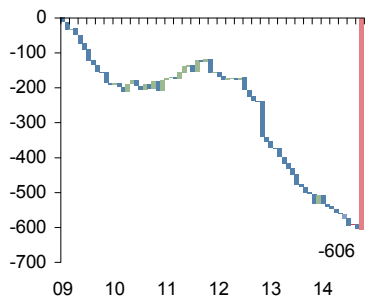
There are several obstacles to an ABS recovery plan. The ABS market has been inactive since the crisis. A recent [consultative paper](#) by the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) shows market participants still see a number of hurdles to growing ABS, including stigma, unfavourable regulation and lack of standardisation. An [ECB-BoE joint paper](#) identified similar challenges.

ABS can help banks improve their capital, leverage and liquidity ratios

Indicative balance sheet of using covered bonds vs ABS to fund an increase in lending

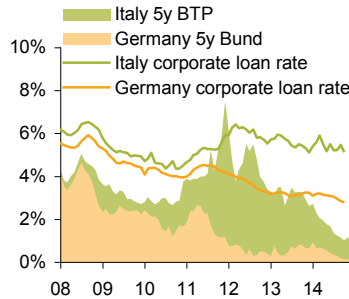


Banks are still cutting lending
Monthly decline in NFC loans, €bn



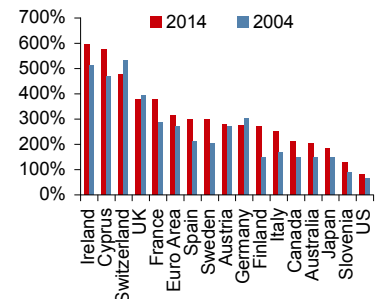
Source: RBS Credit Strategy, ECB

Low yields not passed to SMEs
Sov. yield vs 1-5y corp loan rate, %



Source: RBS Credit Strategy, ECB, Bloomberg

Banks are too large at 3.1x GDP
Bank assets, % GDP

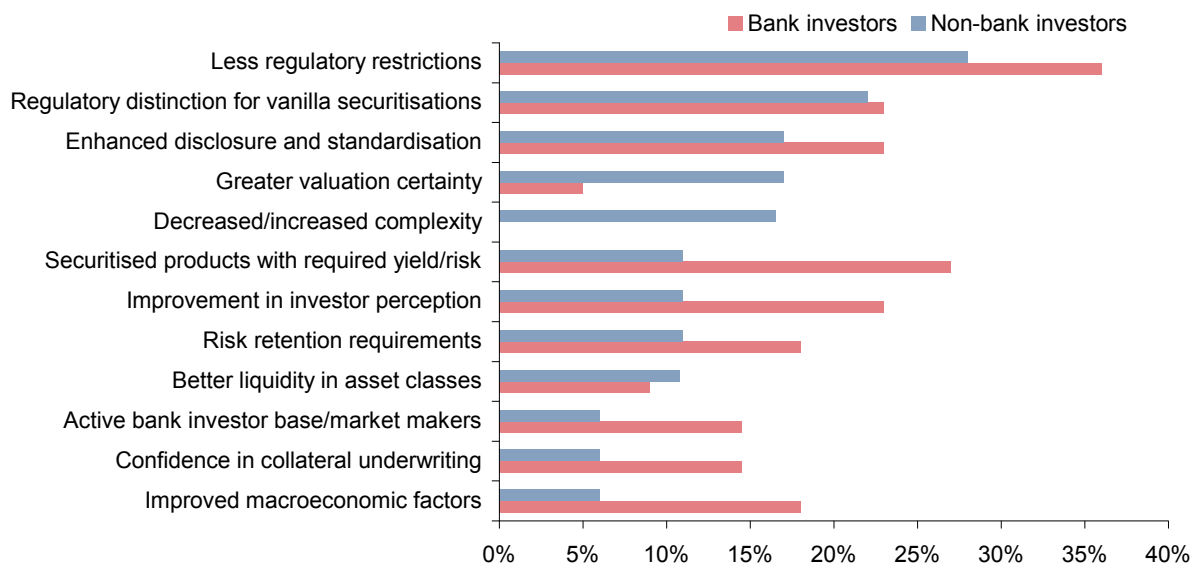


Source: RBS Credit Strategy, ECB, IMF

CHAPTER 2. Challenges to reviving the ABS market

1. High regulatory capital charges discourage investor demand. According to the survey conducted by the BCBS and IOSCO, the regulatory treatment of securitisations vs other products is the biggest hindrance to growing the market. Investors have also suggested that fewer regulatory restrictions and clearer differentiation between vanilla securitisations and more complex products would be the most important factors to attract more investor participation (below). These findings are in line with the [responses](#) collected by the BoE to its joint proposal with the ECB.

Less restrictive regulation and more standardisation will attract more investors
 Investors' view of most important factors for increasing investor participation



Source: RBS Credit Strategy, SCBC, IOSCO

Blamed as the culprit for triggering the crisis, securitised products have attracted much stricter regulatory treatment since 2008-09. For example, the capital charges on securitisations under Basel III and Solvency II are much higher than the previous regimes. The purpose of these changes is to better align the interests of the issuers and investors so as

to reduce future financial stability risk. However, new regulation has also been harsh and does not fully differentiate between securitisations with different structural complexity and underlying collateral quality. This has made it harder for banks to sell the full capital structure of a deal, especially for the equity tranches, against which insurers and banks need to hold much more capital than previously.

2. Lack of standardisation in disclosure and bankruptcy laws across jurisdictions.

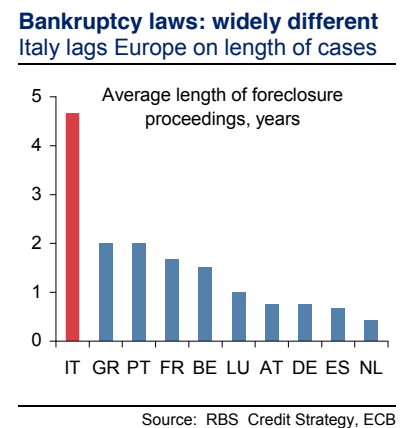
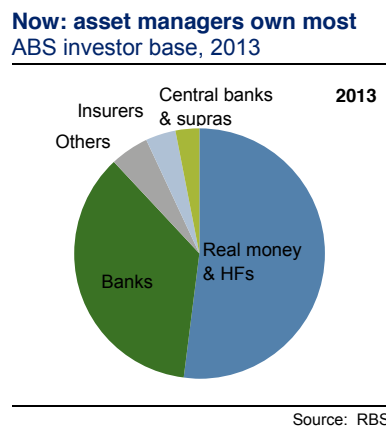
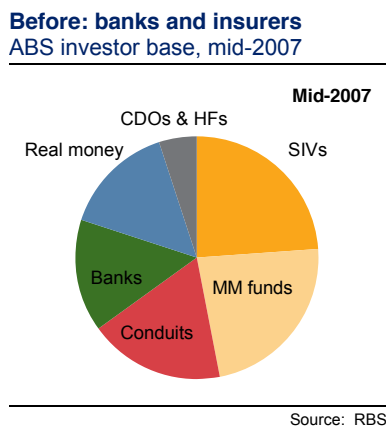
Investors in the BCBS-IOSCO survey also highlighted enhanced disclosure and standardisation as a key factor to attract investor demand. Since the crisis, central banks and national regulators have worked to standardise reporting and improve transparency, for example through the European DataWarehouse initiative. However, while the reporting templates are standardised, the underlying loan markets across Europe are not. There are substantial variations across jurisdictions in terms of underwriting standards, default definitions and bankruptcy procedures. For example, a foreclosure can take 5-10 years in Italy vs around a year in Spain. Such differences will significantly affect investors' recovery forecasts and expected returns, making it harder for them to value securitisations. This could deter potential investors and discourage existing ABS investors from expanding investments in other jurisdictions. More harmonisation on risk transfer rules will also be essential.

3. A shrinking investor base. The investor base for securitisations has shrunk and now only around €600bn of the €1.4tn outstanding is placed with investors, with the rest retained by banks, primarily for ECB repo. This is due both to the unfavourable regulatory shifts noted above and to changes in investors' risk assessment of the asset class since the crisis. The smaller investor base and increased risk aversion add to the challenge banks face in selling all the tranches of a securitisation.

4. Segmentation across the European ABS market. As shown below, Europe's securitisation market is heterogeneous and centred primarily in the UK, Holland, Italy and Spain. RMBS accounts for 60% of the market and SME loans only 8% ([EIB](#)). To ensure an ABS recovery plan can work effectively by boosting lending across the Eurozone, a level playing

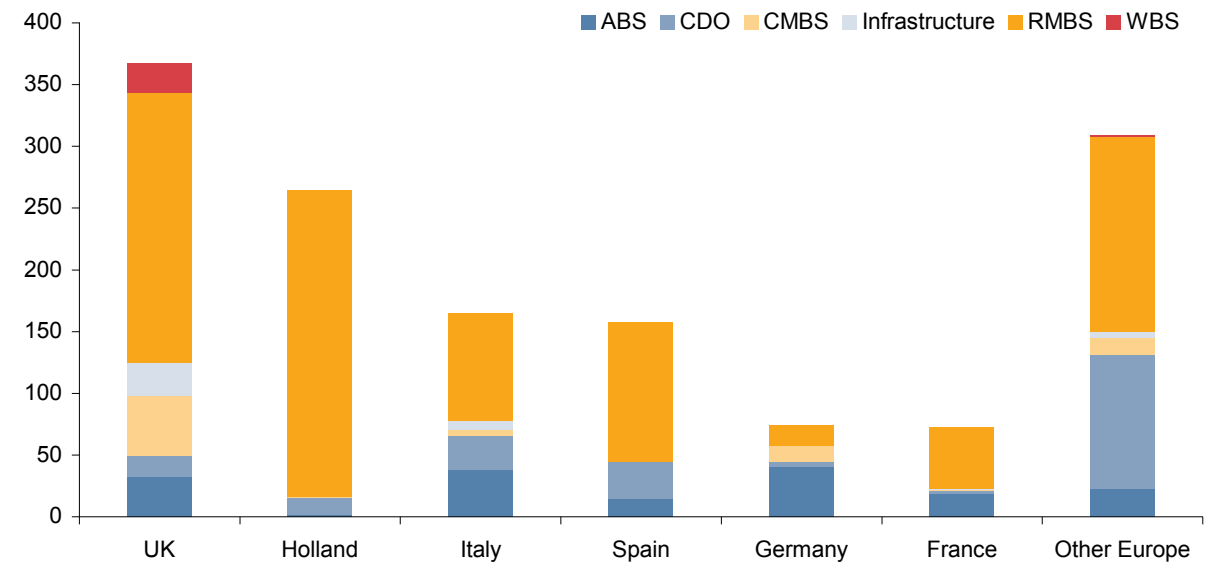
field is important. Again, more standardisation of rules and improved transparency will be essential to reduce such segmentation.

5. The ECB ABS purchase programme is limited to senior without guarantees. Through its purchase programme, the ECB hopes to revive the European ABS market to promote credit growth. As we explain below, the purchases of mezzanine tranches is crucial to ensure the effectiveness of the programme. The ECB has made it clear that it will only buy mezzanine tranches if they are guaranteed. However, so far few governments have expressed willingness to provide such guarantees. Among the biggest economies, only Italy has suggested that it will offer mezzanine guarantees, while Ireland, Luxembourg and Malta also suggested that they may do so. On the other hand, Germany, France and Holland have ruled it out ([Bloomberg](#)).



A segmented market, concentrated in the UK and Holland

European securitisations outstanding, €bn



Source: RBS

CHAPTER 3. Possible solutions

In our view, some key measures that can tackle these problems are:

Lower capital charges and standardised rules for simple ABS. While the Basel committee has maintained its tough stance towards capital charges for banks in its [latest securitisation framework](#), it left the option open to review and potentially reduce capital charges for high quality securitisations in 2015. Together with IOSCO, Basel recently [proposed 14 criteria](#) to identify such “*simple, transparent and comparable*” securitisations. This idea is similar to the “*qualifying securitisation*” proposed by the BoE and ECB. If finalised, the development of a simple ABS which could receive better regulatory treatment and have more standardised features would be key to promoting investor demand, in our view.

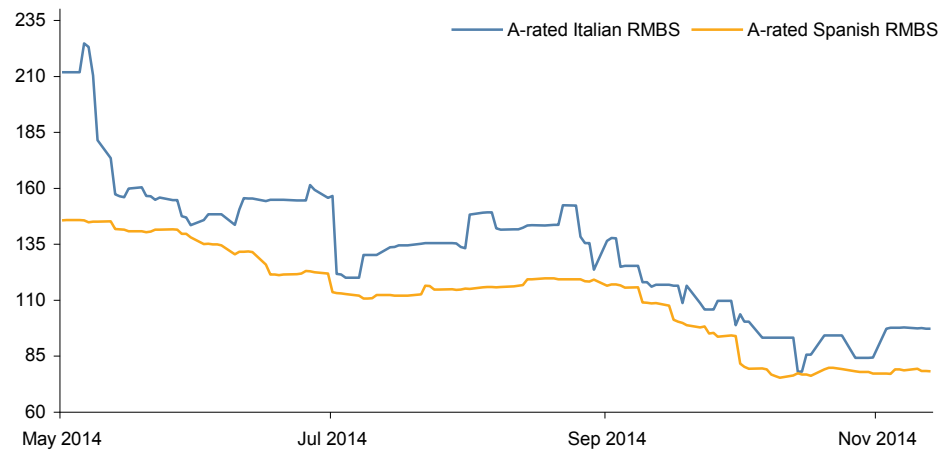
More fiscal support for mezzanine tranches. In addition to the development of simple ABS and enhanced standardisation, we think guarantees for mezzanine tranches are also important for the ABS recovery plan. Besides national governments, national development banks could step in to provide guarantees as well. The European Investment Bank (EIB) or its SME lending-focused subsidiary the European Investment Fund (EIF) could also provide guarantees, which would also overcome the fragmentation problem that would persist if guarantees were provided by national entities.

CHAPTER 4. Why bother about mezzanine guarantees?

The ECB will buy eligible senior tranches and mezzanine tranches if guaranteed. In our view, guarantees are crucial to make the ABS plan effective because:

1. Guarantees and purchases of mezzanine tranches could push down mezzanine yields, allowing higher yields to be paid to equity tranches or lower interest rates to be charged on borrowers. As explained above, the ABS plan will only work to boost lending if banks are able to get capital relief by selling the full ABS structure (less the 5% retention requirement). However, currently this is not always possible given the difficulties in selling the riskier mezzanine and equity tranches. A bank would currently have to hold €60mn of capital against €1bn of loans to SMEs with a 75% average risk weight ($€1bn * 75\% \text{ risk weight} * 8\% \text{ Basel III minimum capital requirement}$). However, if it were to securitise those €1bn of loans with a 10% equity tranche, it would need to sell all of the senior and mezzanine tranches and at least 40% of the equity tranche in order to reduce its capital requirement, given the high 1,250% risk weight on ABS equity tranches (using the standardised approach).

ABS spreads tighten on ECB plan basis points

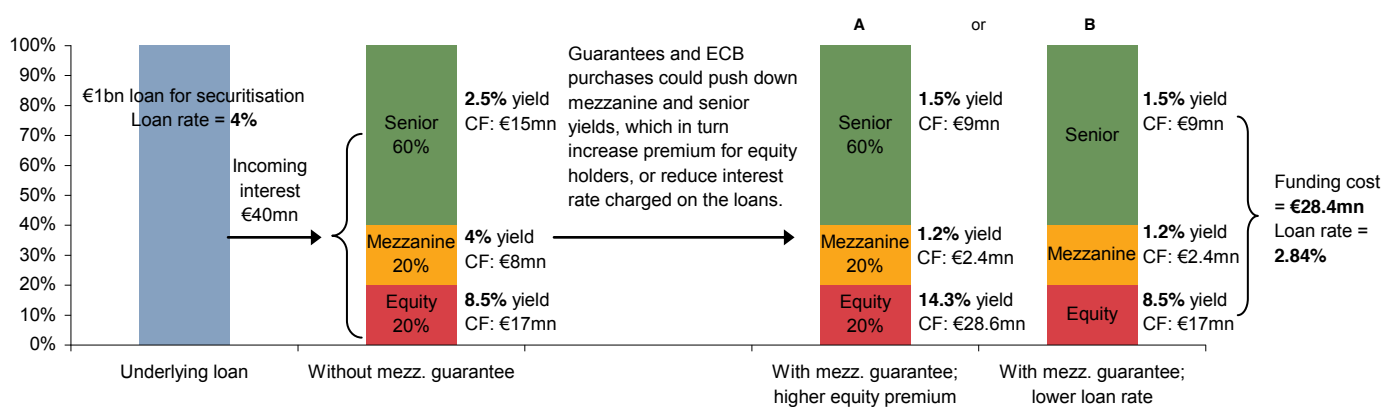


Source: RBS

If governments or public agencies are willing to provide mezzanine guarantees to facilitate ECB buying, the yields on mezzanine tranches could be compressed, allowing more to be paid to equity holders. This would make equity tranches more attractive and easier for banks to sell. As illustrated below, if a bank securitises €1bn of loans which pay an average interest rate of 4%, it will have an incoming cash flow of €40mn each year (assuming no transaction or issuance costs for simplicity). If the deal has a structure of 60% senior, 20% mezzanine and 20% equity, and assuming the yields on the senior and mezzanine tranches are 2.5% and 4% respectively, the maximum yield available for equity holders will be 8.5%: $(€40mn - €1bn * 60% * 2.5% - €1bn * 20% * 4%) / (€1bn * 20%) = 8.5%$. However, if ECB purchases push down yields on senior and guaranteed mezzanine tranches to 1.5% and 1.2% respectively, the yield on equity tranches would rise to 14.3%, or the bank could reduce the loan rate to 2.84%.

Mezzanine guarantees could make it easier for banks to sell equity tranches

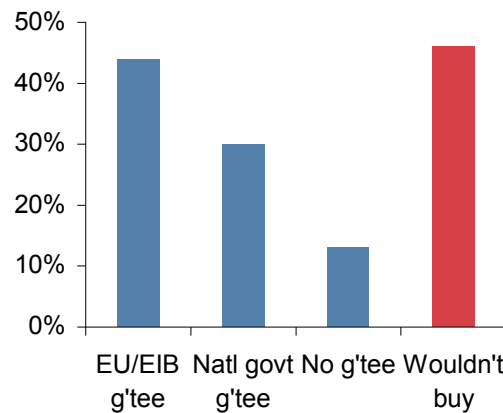
Breakdown of cash flows available to holders of different tranches (indicative ABS structure)



Source: RBS Credit Strategy. The impact of the mezzanine guarantees roughly equals the impact of the senior ECB purchases in this example; both reduce the yield on the loans by around 60bp.

2. More investors would buy ABS. 44% of investors who participated in our [recent survey](#) said they would buy mezzanine ABS tranches if guaranteed by the EU/EIB, while 29% said they would do so if the ABS had a guarantee by a national government or development bank. Clearly then, mezzanine guarantees and the development of a simple and credible ABS instrument (with regulatory harmonisation and more transparent rules) would encourage more private investors to step into the market. For example, ABS with first-loss sovereign guarantee may also attract sovereign, agency or covered bond investors, particularly given ECB purchases of covered bonds and potentially agency and sovereign bonds as well. Furthermore, with guarantees and ECB purchases pushing down yields on senior and mezzanine tranches, existing ABS investors looking for yield may go down the risk spectrum and buy more equity tranches. This would again help the issuer sell the full structure of a deal.

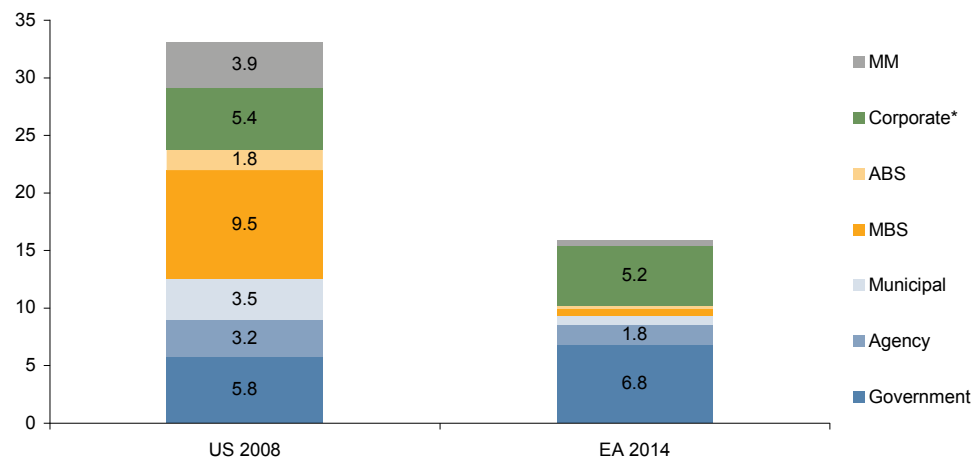
Would buy ABS if it had...



Source: RBS Credit Strategy

3. Reviving ABS with government guarantees and ECB purchases could make sovereign QE more effective. QE has several transmission mechanisms, including injecting liquidity, lowering interest rates, lowering exchange rates, raising asset prices and signalling future policy. But there is also a portfolio rebalancing transmission channel, as shown in the diagram from the Bank of England below. Put simply, if the ECB buys €500bn of government bonds from investors, those investors now have €500bn to invest elsewhere. They may reinvest part of it in government bonds, some may go into similarly risk-free assets and some may go into slightly riskier assets. This starts a chain of investors rebalancing their portfolios, with some of it trickling down into riskier assets, raising prices/lowering yields of high yield credit or stocks, for example.

QE less effective with fewer bonds
 Size of bond market, \$ and €tn



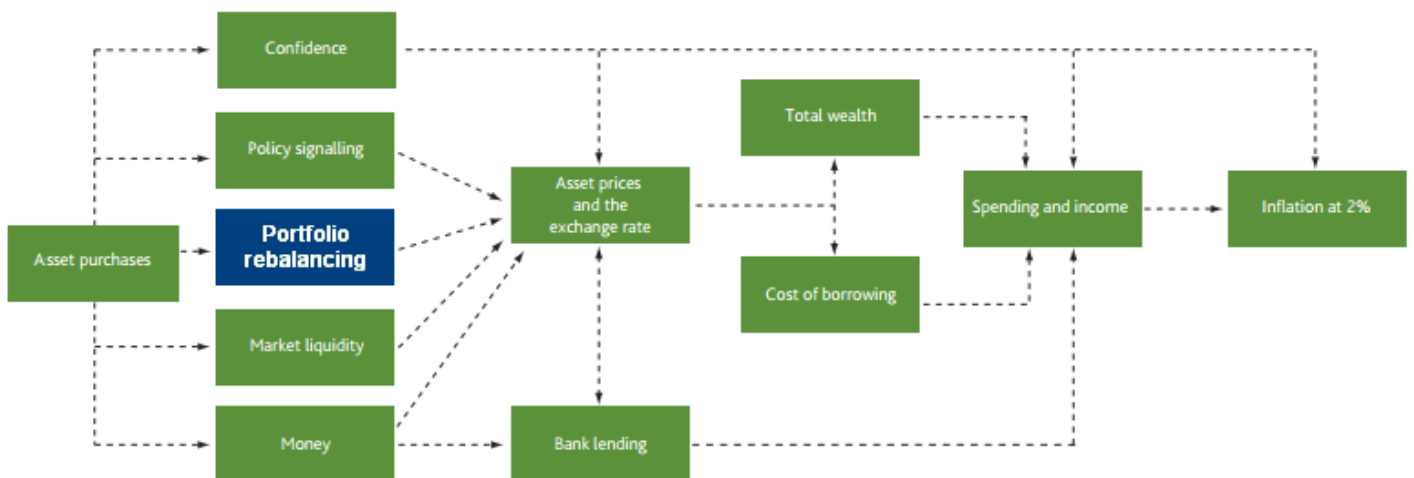
Source: RBS Credit Strategy, SIFMA, ECB;
 * For the Euro area, corporate is mainly banks, including covered

Compared to the US when the Fed started QE at the end of 2008, this portfolio rebalancing channel may be less effective in the Euro area now, given the lack of other fixed income assets available. Absent a similar quasi-sovereign asset class to put their money in, sovereign investors may simply reinvest their money in other government bonds, driving down yields further but without strong impact on the real economy. As shown in the chart above, the major destinations for central bank liquidity are other government bonds or bank bonds. The amount of bonds outstanding from Euro area non-financial corporations is small at around €1.1tn, according to ECB data, and the amount of MBS and ABS outstanding is just €900bn, according to SIFMA, and much of this is retained by banks, so not available for investors to buy. In contrast, the \$4tn+ of bonds the Fed bought under its three QE programmes could have gone into the larger corporate bond market (\$4tn+) or into the rest of the much larger MBS/ABS market (\$11.3tn), trickling down into the mortgage and corporate loan markets that back those assets.

Rebuilding the European ABS market, for example with government guarantees and ECB purchases, could increase the effectiveness of this QE portfolio rebalancing channel. With a suitably large and liquid ABS market – similar to that of the US – investors who sell their government bonds to the ECB may diversify into ABS, directly lowering bank funding costs. If the new-style ABS is linked to new lending, as discussed above, the bank may also be more likely to pass on these lower funding costs to its customers.

Policymakers can help revitalise the ABS market with simpler and more harmonised rules, lower capital charges, mezzanine guarantees and ECB purchases. This could allow banks to expand lending again as well as make ECB purchases of other assets more effective by crowding investors into ABS. This could significantly ease credit conditions and reduce borrowing costs in the real economy, including for small businesses in the periphery, where credit constraints are most severe.

How QE works: rebuilding the ABS market may enhance the effectiveness of the portfolio rebalancing channel



Source: RBS Credit Strategy, Bank of England

CHAPTER 5. What forms could the guarantees take?

The design of any guarantee is vital to ensure ABS can achieve the benefits above:

European securitisation defaults	
Mid-2007 to Q4 2013 cumulative %	
	%
ABS	0.1%
Credit cards	0.0%
Other consumer ABS	0.1%
Other ABS	0.0%
RMBS	0.1%
All consumer transactions	0.1%
All corporate transactions	5.0%
CMBS	10.3%
Corporate securitisations	0.1%
Structured credit	4.6%
Synthetic corporate	2.9%
Leveraged loan CLO	0.1%
SMEs	0.4%
CDO of ABS	41.0%
Overall	1.5%

Source: RBS Credit Strategy, S&P

1. What tranches should be guaranteed? Despite the wide usage of the term mezzanine, there is actually no clear single definition of it. According to estimates by our ABS desk strategists ([ABS RIP to ABS PP: The rehabilitation is near complete](#)), the outstanding amount of bonds that make up the “belly” of securitisation capital structure (not senior or equity tranches) in the Eurozone is around €159bn, or 18% of the securitisations outstanding. However, these include not only standard mezzanine (10-30%) but also riskier junior versions

which are lower down the capital structure. If including only second-pay bonds (excluding junior mezzanine tranches), the market outstanding is €111bn, or 13%.

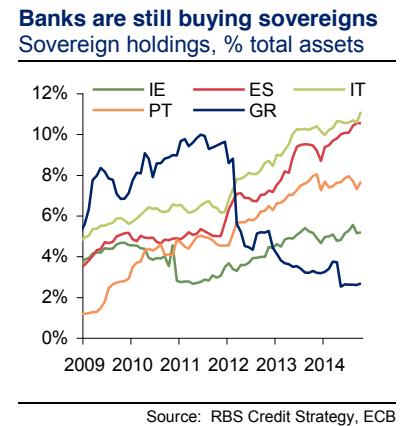
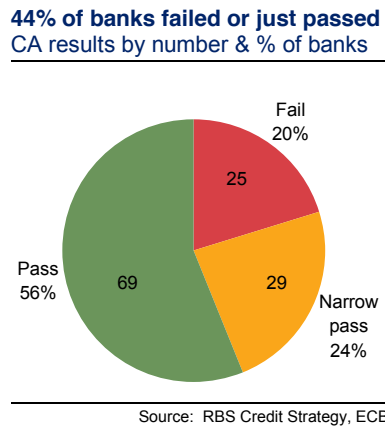
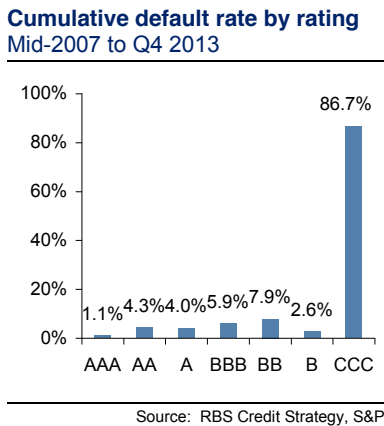
In our view, if the objective is to attract safety-seeking government, agency or covered bond investors, the guarantee need only cover standard mezzanine tranches (e.g. 10-30% of the capital structure), not the more junior versions. As we discuss above, the portfolio rebalancing effect and entry of new investors into the ABS market are important to support credit growth.

2. What type of guarantee? In our view, guarantees of mezzanine tranches should be on a *first loss* basis. This means the guarantor compensates the holders of a mezzanine tranche as soon as the losses occur, within five days. Unlike for residual guarantees, a first-loss reimbursement prevents creditors from having to go through the bankruptcy and loan recovery process before being compensated. This also simplifies the issue of varying bankruptcy regimes in different countries, which would also add to the uncertainty of reimbursement (for example, it takes on average 5 years to foreclose on a mortgage in Italy, vs around 1 year in Spain). First loss guarantees on ABS are currently issued by the EIF.

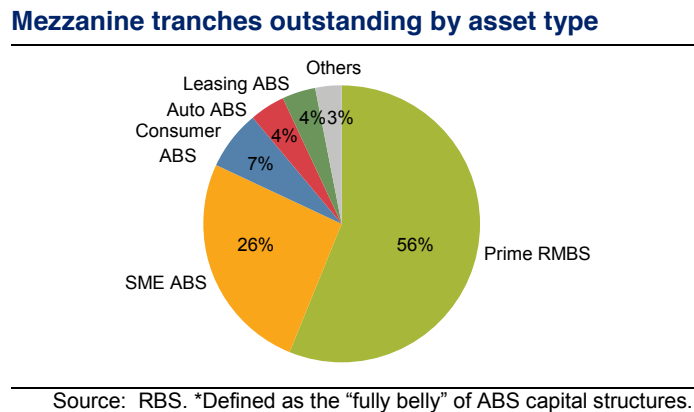
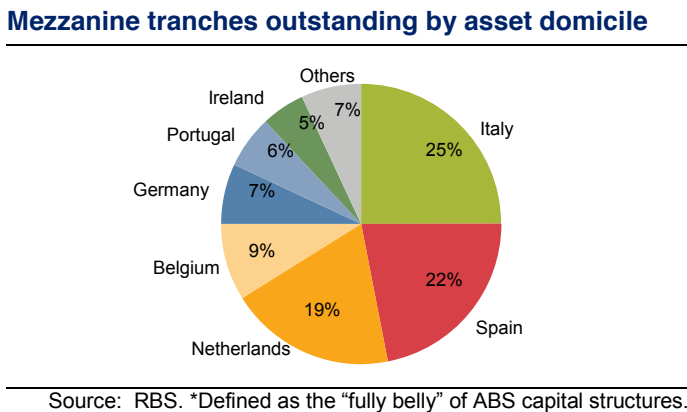
To limit moral hazard, the first-loss guarantee should not cover 100% of losses, leaving private investors still exposed to some risk. The EIB suggests that coverage rates should generally be between 60-80% for first-loss guarantees.

3. Who could provide the guarantees? Guarantees can be provided by either national governments, national development banks or the European Investment Bank (EIB). A pan-European entity like the EIB would be preferable, as it would avoid the fragmentation problem of countries with higher sovereign yields providing guarantees. In any case, it is crucial to ensure that the guarantee only covers the credit risk of the underlying loans, and nothing else. This includes documentation and legal risks, which should still be covered by the issuing entity. A state could fund mezzanine guarantees in one of three ways: it could set aside reserves by allocating the charges to the existing budget, increase borrowing to set aside funds or promise to deliver payment when losses arise. The crucial benefit of the final method is that it does not add to current debt metrics, as new borrowing would do, and does not encroach on the existing budget at all. The issue, however, is the contingent liabilities could crystallise in future, if and

when losses are deemed likely to occur, and bond investors could still price that risk in sovereign valuations.



The EIB and EIF already provide loan portfolio guarantees and other credit enhancement for securitisations under the [SME Guarantee Facility](#) and [JEREMIE](#) programmes. While the EIB’s commitment to its AAA rating could be a hurdle to providing effective mezzanine guarantees, a joint commitment with national governments and other development banks would be useful. This is because not only would it allow for burden sharing, but would also enable the EIB and EIF to lend their expertise in due diligence to the project.

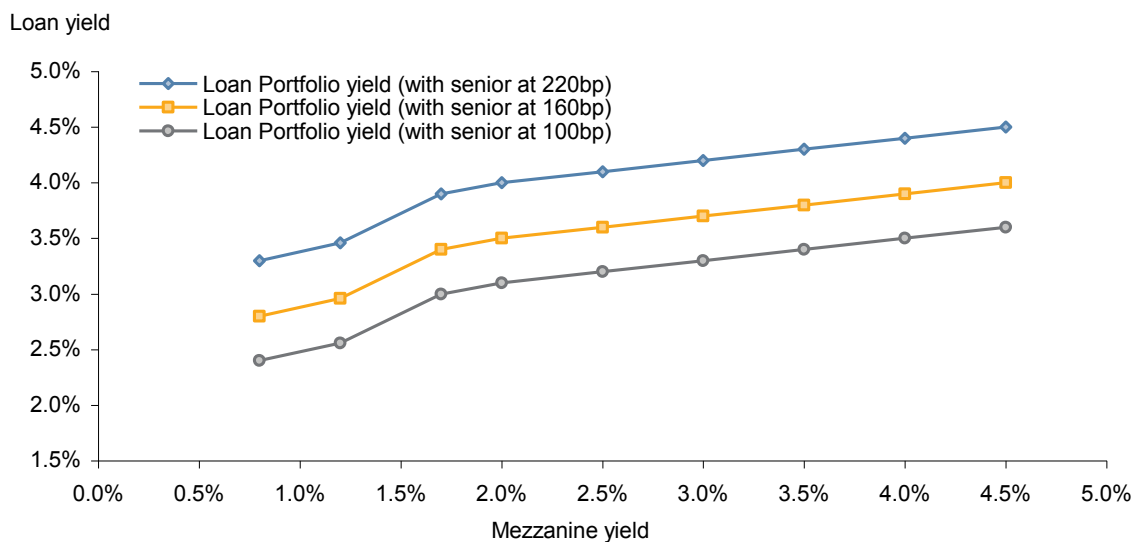


4. Pricing of guarantees. Guarantees and subsidies can be priced on the [basis of a spread](#). The premium paid for a guarantee should be based on the difference between the yield of the guarantor and a similar non-guaranteed mezzanine tranche, with an added liquidity premium.

Example: For a €1bn securitisation with an unguaranteed mezzanine yield of 4%, let's assume the EIB fully guarantees the mezzanine tranche and demands no extra premium from the issuer on top of its own funding costs. In this case, the issuer would pay a premium to the EIB for the guarantee equal to the EIB's funding cost, currently around 70bp in 10-year.

The yield on the mezzanine tranche would therefore equal the EIB's funding cost of 70bp¹, plus a liquidity premium (e.g. assume 50bp) demanded by investors, so 120bp in total. This would save 280bp over the original, unguaranteed mezzanine funding cost of 4%. The lower funding costs for the guaranteed mezzanine tranche could then be redistributed to equity tranche holders or passed on to the households and SMEs borrowing the underlying loans through lower interest rates, shown earlier.

Benefit to loan portfolio spreads
 Loan portfolio yield reduction vs mezzanine tranche yield



Source: RBS

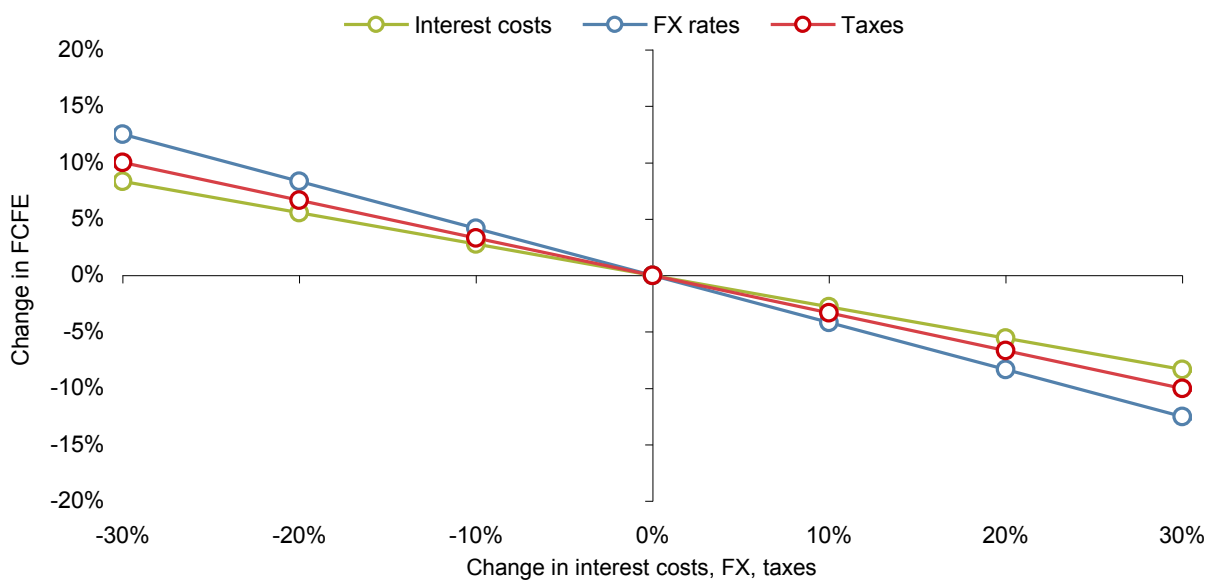
¹ The EIB or national governments may ask for an additional credit risk premium on top of their funding costs. Alternatively, if the Italian government provided the guarantee, the mezzanine yield would equal around 200bp (10-year BTP yield) plus the liquidity premium.

5. Benefits for SMEs. Generally, we estimate that for a 2% reduction in the funding cost of a mezzanine tranche (e.g. a 10-30% tranche), the loan cost for borrowers would fall by 40bp, roughly 10% of funding costs for SMEs starting from a current average loan rate of 4.5% in the periphery.

Given the rise in leverage of periphery firms due to lack of earnings growth over the past years, the benefit to the SME in the *cost of credit* would be substantial. We calculate that for a 5x levered SME (measured in terms of Net Debt/EBITDA), a reduction in interest costs by 10% (i.e. from the interest rate on its loans falling to 4.5% from 5%), would result in an increase in free cash flow of almost 10%.

This would be comparable to similar relative amount of tax reduction or a reduction in the Euro exchange rate. Of course the impact of an interest rate reduction will favour levered firms, while currency depreciation will favour exporters more – yet, levered firms in the periphery now account for a large chunk of the total, as shown below.

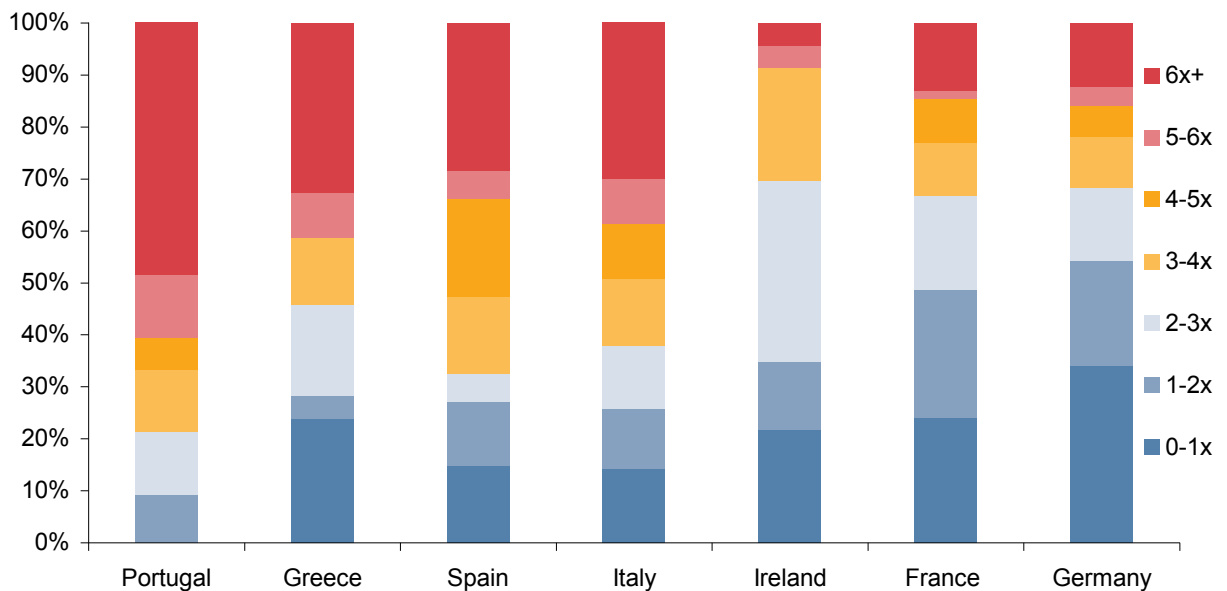
Benefits of loan rate reduction to SME free cash flow, depending on debt/assets ratio
 Scenario for an average periphery SME for changes in interest, FX, taxes



Source: RBS

Leverage distribution in periphery SMEs

Net Debt/EBITDA for periphery firms, distribution for all listed companies



Source: RBS, Bloomberg

6. Conditionality is crucial to prevent adverse selection and moral hazard among participating banks and ensure guarantees produce an increase in lending. Eurozone banks remain weak. As the ECB Comprehensive Assessment results have shown, 20% of banks failed the tests while 24% only passed by a narrow margin. This means any public guarantee programme could face two potential risks:

a) adverse selection if only weak banks participate in the programme in order get cheaper funding and capital benefits, but do not pass the benefits to the real economy through more lending or lower interest rates.

b) moral hazard if banks are not incentivised to use guarantees for issuing new loans, even if they have the capability to do so. As the past experience of LTROs shows, periphery banks may find it more attractive to engage in carry trades by buying sovereign bonds with cheap ECB liquidity, rather than lending to the real economy.

Therefore, we think any public guarantees should come with conditions on:

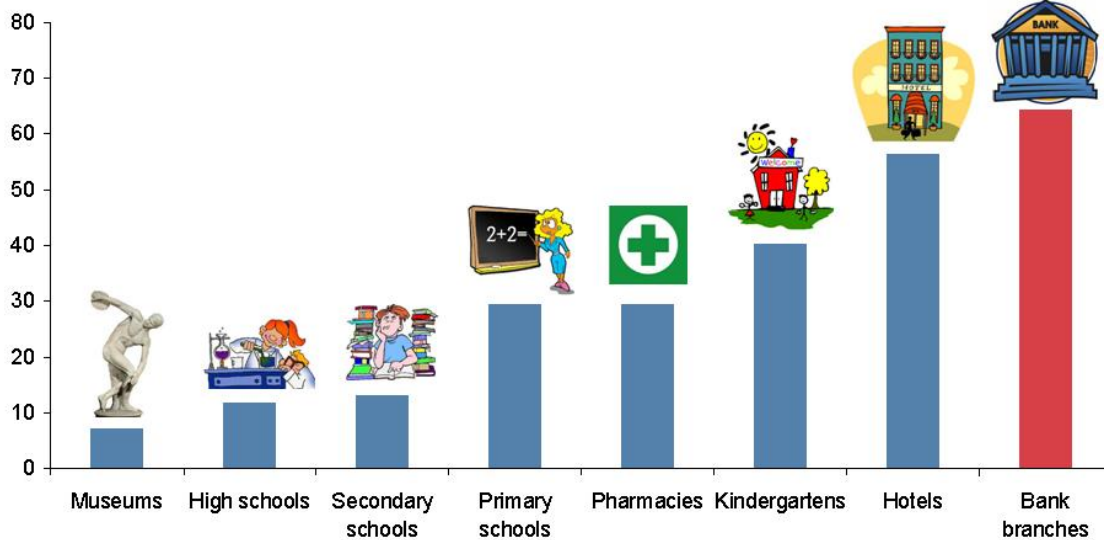
a) Minimum fundamental strength of participating banks. To prevent adverse selection, participating banks should meet certain minimum requirements in terms of their fundamental strength to ensure that they have the capability to actually use any capital relief achieved to increase new lending. For example, eligible banks could be limited to those that have passed the Comprehensive Assessment or those meeting a minimum capital ratio requirement.

b) Commitment to expand lending activity. The guarantees themselves should also be conditional on banks making new loans and be assessed on an ongoing basis: a mechanism should exist under which an issuer may lose the access to guarantees if their lending does not rise above a pre-defined rate. Also, guarantees should only be made available for deals with certain simple structures, encouraging standardisation.

CHAPTER 6. The Italian case and the need for bank reform

Italy's economy and its banks had many strengths early in the crisis. Italy's banking system is smaller than its European peers, at around 2.5x the size of GDP vs 3.3x across the Eurozone. Unlike Spain, Ireland and the UK, Italy never experienced a large housing boom. As a result, Italy entered the crisis with a more balanced economy, not too focused on construction and real estate, and Italian banks also avoided large real estate and developer NPLs. Mortgage debt is low at 19% of GDP vs 60% in Spain and mortgages tend to have shorter terms. Consequently homeowners are less leveraged, instead saving for longer to buy a house outright or with a small, short mortgage.

Extensive branch network imposes heavy costs on Italian banks
Number per 100,000 people



Source: RBS Credit Strategy, World Bank, OECD, ISTAT

But resiliency has at times become resistance to change. Despite the initial strengths, Italy now finds itself in a worse situation than Spain and Ireland, which are now reaping the benefits of reforms. Italian banks are suffering from increasing NPLs, which now account for around €175bn, according to the Bank of Italy. Italian banks have so far not engaged in consolidation and reform, and remain fragmented and inefficient. There are more bank branches per person in Italy than restaurants or pharmacies, the most in any other OECD country (see also [The Revolver | Italy: Time for bank reform](#), January 2014).

The ECB stress test confirmed that the Italian banking system is fragile, and Italy reported the highest fail ratio (9 out of 15 banks failed the test). In particular, even the Asset Quality Review (AQR) found capital shortfalls relative to the classification and risk-weighting of assets, in sharp contrast with previous reassurances from Italian regulators.

Even if bad loans subside as the economy recovers, the Italian banks' underlying profitability will remain structural low if reforms are not implemented swiftly, as costs and inefficiencies remain high. Costs, lack of profitability and fragmentation are one issue, highlighted above. The recently announced reform of the *popolari* banks' voting system could favour consolidation and mergers in the sector, eventually improving cost efficiency.

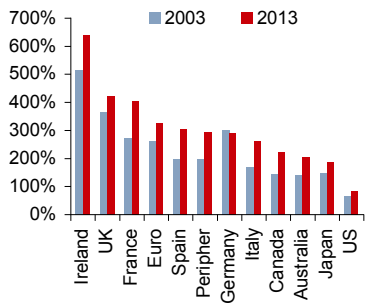
Secondly, Italy suffers from one of the slowest justice systems in developed markets. This affects all forms of business – for banks, it means the recovery process for non-performing loans lasts between 5-10 years, and it means NPLs stay on a bank's balance sheet, absorbing capital and preventing a quick clean up of balance sheets. There is still lack of clarity on how deep and effective the justice reform will be.

The result has been a de-leveraging of around €100 of non-financial loans in Italy, where over 20% of SMEs say accessing credit is their main problem. Now, it is a frequent response from banks to address the situation as simple "lack of demand". This is a superficial response, in our view, firstly because demand depends on price, and banks are the ones who set loan rates – currently around 2% higher in Italy than in other countries. But due to the inefficient judicial system and slow recovery process, Italian banks also tend to set tight non-price conditions to obtain credit, like guarantees, or overcollateralization.

Bank reform has already been successful in Ireland and Spain. Italian banks need to consolidate, reduce costs and resolve NPLs in order to raise underlying profitability to more sustainable levels, as their peers have done in Ireland and Spain. Italy contributed to the ESM loan to fund Spain's €41.4bn bank bailout, but has been reluctant to pursue reforms domestically. Ireland and Spain increased provisions and created bad banks NAMA and SAREB to take the most toxic assets from banks. Both banking systems were consolidated,

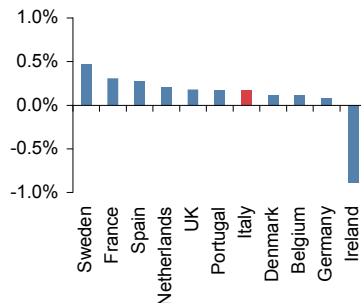
particularly in Spain, which shrunk 45 banks and cajas to just 11 groups and is also shrinking its extensive branch network. It worked well. Even the weaker mid-tier banks in Ireland and Spain have returned to capital markets to issue senior bonds. Transparency has also helped to boost equity valuations: the average price/book ratio of banks in Spain and Ireland is now above 1x, compared to less than 0.6x in Italy, where such reform is still lacking. Improving valuations have helped these Spanish and Irish banks to raise capital cheaply, as many recent cases show. If these measures have worked for Ireland and Spain, they could also help Italian banks and accelerate the recovery.

Italian banks are smaller...
Bank assets, % GDP



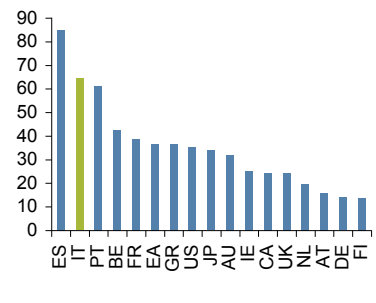
Source: RBS Credit Strategy, IMF, ECB, RBA, BoJ, Fed, BoE

... but less efficient...
Ave. return on assets, 2007-13, %



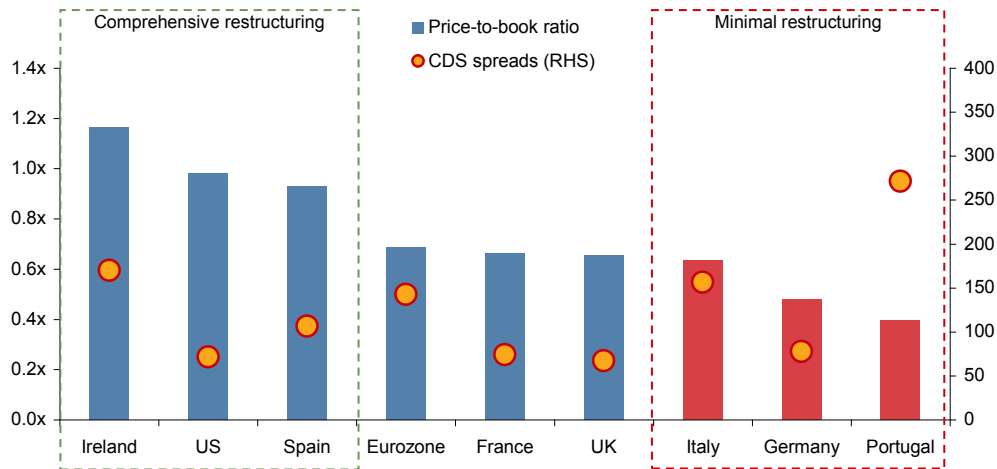
Source: RBS Credit Strategy, Bloomberg

... and cost-heavy
Bank branches per 100,000 adults



Source: RBS Credit Strategy, World Bank

Banks which have reformed trade at a premium and can raise capital cheaply
Average price-to-book multiples for listed banks, and average 5-year credit default swaps spreads



Source: RBS

In conclusion, ABS could help SME credit to re-start even in Italy, where bank reforms have not been undertaken so far, and where NPLs and lack of capital remain a high hurdle for banks to lend. **But Italian authorities should not see action on ABS as a substitute for bank reform.** In the long run and in the face of another crisis, only efficient, profitable banks will be able to recover.

Bibliography

A. Gallo, S. Sethi, T. Pan, X Chen, L. Tyrrell-Hendry, "[The Revolver | European banks: Still too big to fail](#)" (23 January 2014)

A. Gallo, S. Sethi, T. Pan, X Chen, L. Tyrrell-Hendry, "[The Revolver | Italy: Time for bank reform](#)" (15 January 2014)

Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions joint consultative paper, "Criteria for identifying simple, transparent and comparable securitisations" and "Revisions to the securitisation framework" (11 December 2014) <http://www.bis.org/>

Bank of England and European Central Bank joint consultative paper, "The case for a better functioning securitisation market in the European Union" (29 May 2014) <http://www.bankofengland.co.uk/publications/Pages/news/2014/082.aspx>

D. Revoltella & others of the European Investment Bank, "Unlocking lending in Europe" (23 October 2014), <http://www.eib.org/infocentre/publications/all/unlocking-lending-in-europe.htm>

European Investment Bank, "Support to SMEs 2008-2010" (19 July 2011) <http://www.eib.org/infocentre/publications/all/the-eib-group-support-to-smes-2008-2010.htm>

R. Buergin & J. Stearns, "Euro Area Split on State Guarantees for ECB's ABS Drive" (13 Sept 2014) <http://www.bloomberg.com/news/2014-09-13/euro-area-split-on-state-guarantees-for-ecb-s-abs-drive.html>

G. Rajendra, P. Boyidapu, S. Narayan, "[ABS RIP to ABS PP: The rehabilitation is near complete](#)" (November 2014)

European Banking Authority, "Guidelines on Significant Credit Risk Transfer relating to Articles 243 and Article 244 of Regulation 575/2013" (7 July 2014)

<http://www.eba.europa.eu/-/eba-publishes-final-guidelines-on-significant-credit-risk-transfer-for-securitisation-transactions>

European Investment Fund, "Handbook on JEREMIE Holding Fund Operational Procedures"

http://ec.europa.eu/regional_policy/thefunds/instruments/jeremie_en.cfm#

T. Magnusson, "Sovereign Financial Guarantees" (19 April 1999)

[treasury.worldbank.org/.../Sovereign Financial Guarantees Apr 99TM.pdf](http://treasury.worldbank.org/.../Sovereign_Financial_Guarantees_Apr_99TM.pdf)



Authors

Alberto Gallo, Head of macro credit research, Royal Bank of Scotland

Lee Tyrrell-Hendry

Tao Pan

Mateja Popovic

Ashleigh Grant