‘Restarting the SME credit market in Europe: what role for securitisation and the capital markets?’’

Hosted by Othmar Karas, MEP, moderated by Corien Wortmann-Kool, MEP
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REPORT

On 9 April 2013, UEAPME, AFME (Association for Financial Markets in Europe) and ACCA (the Association of Chartered Certified Accountants) jointly organized a roundtable called **“Restarting the SME credit market in Europe: what role for securitisation and the capital markets?”** hosted by **Othmar Karas, MEP (EPP, Austria)** at the European Parliament in Brussels. The aim was to discuss how to ensure a careful revival of SME loan securitisation, building on the recent promising developments in this market. The main conclusions indicate that while Europe still remains strongly dependent on bank financing, alternative finance sources need to be explored. Securitisation has the potential to spread risk intelligently, but we need more transparency, public guarantees, regulatory certainty and proper use of information. It is essential to continue the dialogue between institutions, stakeholders, banks and businesses in order to retrieve investor’s confidence.

The roundtable was moderated by **Corien Wortmann-Kool**, MEP (EPP, the Netherlands). The panel was comprised of **Alessandro Tappi**, Head of Guarantees, Securitisation & Microfinance, European Investment Fund, **Richard Hopkin**, Managing Director in the Securitisation Division, AFME, **Vilmos Budavari**, Unit SME access to finance, DG Enterprise and Industry, European Commission, **Emmanouil Schizas**, Senior Economic Analyst, ACCA, **Gerhard Huemer**, Director Economy Policy, UEAPME. The event was attended by over 100 participants.

<u>Discussions revealed that</u>:

- Further support mechanisms are necessary to help boost the supply of credit for, and encourage investment in SMEs, since 80% of their financing is through loans. Would-be lenders to SMEs typically face two major challenges: high credit risk and higher costs of capital when lending to small businesses. Speakers stressed the need for alternative finance solutions in the long term, involving more equity financing but also collateral or guarantees through public funds. However, they also noted that it will take time to diversify EU SMEs’ financing away from debt – hence in the medium term it is important to facilitate lending to SMEs through securitisation.
- There is now a consensus that securitisation, used in the right way, could spread the risk involved in SME lending intelligently. It is imperative however to create a proper set of instruments. To achieve recovery in securitisation, simplicity and transparency of structures, as well as regulatory measures will be needed. The European Commission and the European Investment Fund are supportive of the tool and are committed to promoting access to SME bond markets and securitisation. The newly published Green paper on long-term finance includes a section covering securitisation, though some speakers regretted that the Green Paper seemed too soft on the regulatory incentives against investing in SMEs.
- Securitisation is only another way of combining the same raw materials of finance: information, control, collateral, and risk. The more it relies on information, the better the outcomes for all parties. Credit rating agencies have traditionally helped reduce the cost of producing such information, but current proposals for rating agency liability could make ratings impossible and cause the market to freeze as it did in the US between 2010 and 2011. Another way is to improve the opacity of products through initiatives such as the Prime Collateralised Securities (PCS) label.

Main highlights

Othmar Karas, MEP, underlined the importance of the topic.

- In the aftermath of the economic and debt crisis, SMEs remain the backbone of the real economy. It is of utmost importance that SMEs have the financial capacity to make the impact necessary to restore economic growth. Yet, the real economy in Europe is mainly financed by credit - at a rate of 80 %. One of the key concerns is to create a broader financing base for SMEs. The European Parliament (EP) has shown its commitment to supporting SMEs by backing an initiative report of Philippe De Backer, MEP (ALDE, Belgium) on "Improving access to finance for SMEs".

- SMEs need to gain even more the support of the financial world through a revitalised dialogue between institutions, stakeholders, banks and businesses. At the same time, we need to draw our lessons learnt from the crisis and foster sustainable financing bases for enterprises to secure, in the long run, economic growth, employment and prosperity in Europe. Othmar Karas highlighted some ways on how to achieve that:
  - The EP has successfully implemented an SME supporting factor in CRD IV to allow for a differentiated assessment of risk associated with lending to SMEs. It serves as a support mechanism for banks investing in SMEs which will help boost the supply of credit for SMEs. Furthermore, alternative ways of evaluating risks should be sought to better reflect business realities. For instance, multidimensional psychometric tests could be carried out in addition to traditional rating processes carried out by banks.
  - Pilot experience needs to be gathered about the combination of equity investment with collateral or guarantees through public funds. The availability of guarantee (or counter-guarantee) instruments in combination with reasonable collateral for enterprises has been identified as crucial.
  - Securitisation can spread risk intelligently. At the national level, intensified dialogue for the standardisation of best practices could help create consistent schemes across countries. On the EU level, a new Risk Sharing Instrument for pilot purposes is in preparation within Horizon 2020. The European Investment Fund also looks carefully at alternative solutions boosting innovative lending such as crowd-funding.
- Equity financing, SME lending and the capacity of public instruments and funds need to be enhanced, in addition to a re-definition of risk assessment and rating tools.

The roundtable was moderated by **Corien Wortmann-Kool**, MEP. She highlighted that the European Parliament has put SMEs at the heart of its work, namely on the CRDIV issue. Some considerable progress needs to be made in improving the set of instruments. It is important to look to the future: when the economy starts its recovery, the need for access to finance for SMEs will rise considerably. It is essential to continue the dialogue in order to achieve progress.

Alessandro Tappi, Head of Guarantees, Securitisation & Microfinance, European Investment Fund (EIF)

- EIF is a European Institution, founded in 1994, that supported over 1 Million SMEs over 15 years. The main shareholders are EIB (62%) and EC (30%).In early 2000 it started to do the first SME securitisations, precisely when the market started to develop, and still operates in this market, as securitisation is an efficient way to support SME financing.

- The EIF has a two-fold business model in support of SMEs - as an investor in equity funds and as a guarantor. It uses its own capital as well as mandates from third parties to mobilise resources for new SME funding and to promote entrepreneurship and innovation across Europe. The bulk of the resources under mandates come from the European Commission. .

- EIF targets the market gaps which prevent SMEs from getting access to finance. SMEs typically face two major challenges: high credit risk and the cost of financing. This prevents them from receiving as much credit as they could have. Under the EC mandates EIF does not typically charge a premium for its guarantees, but requires commitments from banks to reduce their lending charges and/or increase their lending.

- Challenges for banks include having funding and capital in order to be able to lend to SMEs. Securitisation can offer a solution for banks. EIF does not provide capital to banks, but with its guarantees EIF may release capital absorption from the banks by taking the credit risk out of their balance sheets. EIB is a part of the system by providing global loans to banks for the SME lending. That compliments the EIF activities because it provides long-term funding to banks to enable them to offer SME loans. With three instruments – securitisation, portfolio guarantees and long term funding – the EIB Group offers a full palette of instruments for the credit market.

- Securitisation is just an instrument. If it is used in the right way, it is a good way to spread risk among market participants. There have been no losses for investors from bank balance sheet SME securitisation issuance in Europe.

Richard Hopkin, Managing Director in the Securitisation Division, AFME

- Europe is very dependent on bank financing. We have to build up alternative financing sources for SMEs that are less dependent on our banking system. He explained the size of the EU banking system and the task of deleveraging: some sources suggest that as much as €5.1tnwill be needed to bring the Eurozone area back to levels close to Australia or Japan.

- Figures demonstrate decline of securitisation issuance since 2006/07. Considering the breakdown of issuance by type of borrower, SME securitisations placed with real investors are a very small proportion, even if many transactions have been structured and placed with the central bank for repo purposes. While this funding support is appreciated and extremely important in the financial system in this challenging time, it is not a long term solution for bringing real investors back to the market.

- Richard Hopkin discussed the ABLe report – an Agency for Business Lending. This was set up following the Breedon report in order to explore better access for SMEs to the capital markets. Participants of the project were drawn from many fields of expertise: business and industry, accountancy, law, academics, investors, and banks. The focus was on longer term or “patient” finance with a maturity of 5 years plus.

- It is difficult for SMEs to access the capital markets – they may not have the resources and expertise, costs can be high and minimum amounts required by investors may be too large. The Agency for Business Lending is meant to be a bridge to the capital markets. The Agency should be agnostic about funding and risk transfer solutions. Anything that works should be considered – it might be securitisation, covered bonds, sponsored funds, retail and investment, synthetic credit risk transfer or existing schemes. It needs to be aligned with the Business Bank which is in the process of being set up. The existing infrastructure should also be leveraged so it is important to ensure the involvement of existing originators.

- High quality securitisation, of SME loans and other real economy assets, has a crucial role to play in funding growth. We appreciate the increasing number of positive statements from senior policymakers which support securitisation, including in the Commission's recent Green Paper, but it is essential that this is translated into evidence-based, sensibly calibrated and non-duplicative regulation on the ground.

Vilmos Budavari, Unit SME access to finance, DG Enterprise and Industry, European Commission.

- He presented the European Commission's perspective on securitisation and described the evolution of securitisation issuance in recent years. Vilmos Budavari stressed some structural flaws of securitisation leading up to the crisis: misalignment of incentives; lack of transparency and complexity in transactions; over-reliance on ratings. Past securitisations were too complicated to understand for many investors who then relied too much on rating agencies without performing their own due diligence. Investors are very cautious at the moment. There has been a considerable drop in European securitisation issuance since 2008. Moreover, securitisation is suffering from a stigma.

- Banks are continuing their deleveraging e in Europe. A big number of SMEs depend on bank loans; they have very little access to public capital markets. We need to come up with solutions to find alternative financing solutions for SMEs to fill the financing gap left by banks.

- Comparing the portion of securitisation in the US and Europe, US numbers are much bigger than in Europe, in part because of government support. But there is the potential to close or at least to narrow the funding gap in Europe. Vilmos Budavari named some measures addressing securitisation markets: risk retention measures, such as risk retention rate in CRD II, Basel III requirements for re-securitisations. There are new initiatives from public authorities on how to increase transparency: ABS loan-level initiative by the ECB; as well as MIFID that will require pre and post trade transparency for securitised products. Some issues have been addressed by the PCS initiative. Challenges remain on the demand side: loss of investor's confidence and the uncertain economic environment. The challenge on the supply side is the uncertainty about regulatory reforms.

- The nature of SME securitisation is complex and not something that can be quickly resolved, but if we have proper due diligence and the right pricing, then investors hopefully will be willing to invest in these instruments. He named key factors for securitisation to recover: simplicity and transparency of structures; standardization; more placement of securitised products with investors; regulatory certainty. The EC is positive about SME loan securitisation and has proposed a securitisation instrument in its COSME programme.

- He referred to the Green Paper on long-term finance and noted that the responses will feed into the Commission's thinking regarding future action. He mentioned the Commission's request to EIOPA to examine whether the calibration and design of capital requirements for investments in certain assets under the envisaged Solvency II regime necessitates any adjustment or reduction under the current economic conditions, without jeopardising the prudential nature of the regime He underlined that a response is expected in June 2013.

Emmanouil Schizas, Senior Economic Analyst, ACCA.

- He provided some numbers showing how critical it is to kick-start the market: the required deleveraging among EU banks is likely to take another 5 years – during which time lending to SMEs is unlikely to increase substantially. While CRD IV in its current form presents a good compromise between financial stability and SME growth, the Basel III paradigm for capital and liquidity regulation in general will tend to make SME lending more expensive, and force banks to shift their business models away from SME lending.

- While the banks' appetite for SME loans is weak, investors' appetite for SME credit as an asset class is quite strong. As long as this gap exists, the potential will also exist for securitisation to fill the gap. Emmanouil Schizas demonstrated that banks do not expect major problems in disposing of SME loans on their portfolios and pointed to the growing number of peer to peer lenders in Europe specialising in business loans as evidence that even *retail* investors have a strong appetite for SME credit – even when, unlike savings, it doesn't come with a government guarantee. . In his opinion the reactions of institutional and retail investors to banks' deleveraging efforts is evidence of the demand for SME credit and a good measure of the market.

- He expressed concern for the fact that, depending on who you ask, securitisation is sometimes described as innovation, sometimes as arbitrage and sometimes –unfairly- as an invitation to fraud. In defence of securitisation, he noted that the raw materials of access to finance are not money, but information, collateral, control and risk appetite. The industry, and therefore securitisation itself, can only create value by creating better ways to combine these materials together. One way of reducing the cost of producing information in securitisation is through credit rating agencies, but Emmanouil Schizas highlighted that current proposals for rating agency liability could make ratings impossible and cause the market to freeze, just as they did in the US in the early days of the Dodd-Frank Act. He stressed that the Americans corrected their mistake within a year, but this is time Europe cannot afford to waste. A lot of the products will live or die depending on what information they can give to the investors that they can trust.

Gerhard Huemer, Director Economy Policy, UEAPME.

- At the moment Europe is in a very critical situation regarding the access to finance for SMEs and it will get worse when the economy restarts. 80% of SMEs are financed by loans. You will not be able to find banks ready to take the risk to finance an innovative project, as they are deleveraging, they are forced to take less risk.

- There might be other alternative ways of financing, but only less than 1% of SMEs have access to this kind of finance. UEAPME is trying to motivate SME owners to do more equity finance, but the tax systems are a barrier in some European countries.

- One of the ideas is to bring bundles of SMEs to the stock exchange. The other idea is securitisation. At present the tax-payer is carrying the risk. This is a short-term solution to survive in crisis, but we need private investors to take the risk for long-term solutions. Securitisation can sell the risks to investor market.

- He mentioned the Green Paper on long-term finance and expressed his disappointment, arguing it is too soft on the regulatory incentives against investing in SMEs. We have to go further in this direction. Securitisation will not solve all the problems, but it can contribute to improvement if it is done transparent and in a way that investors trust the instrument.

Corien Wortmann-Kool, MEP concluded that it is important to carefully assess the Green Paper responses before deciding on any policy. She also asked the panellists what is needed to support a recovery of the securitisation market. **Gerhard Huemer** said that it is public guarantees - public support is essential. **Emmanouil Schizas** - more information and ways to use it. **Vilmos Budavari**- we need to set up financial instruments and have them running by 01.01.14. **Alessandro Tappi** is believer in securitisation; it is the way to leverage. **Richard Hopkin** noted strong signalling from authorities that securitisation is approved; transparency is good and getting better – we need to acknowledge and recognise that.

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