RISK CONTROL

How Securitization Could Assist European SME Financing

Presentation by William Perraudin
to the BIAC-G20 Paris Roundtable
4th June 2015

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Introduction

European SMEs - primary casualties of the crisis:

- European SMEs have been among the primary casualties of the credit crunch that has gripped much of Europe since the crisis of 2007-8 and the subsequent European sovereign debt crisis of 2011-12.

Pressure on the banks:

- Banks' attempts to rebuild their balance sheets and meet stringent new capital requirements have led them to scale back their lending.
- Liquidity requirements and moral suasion from governments have led many European banks to substitute investments in their national governments' debt for corporate lending.
- The result has been high lending spreads and rejection of many loan applications for SMEs particularly in periphery countries.

Securitisation as a solution:

- The problem could be solved in part by reviving the European SME-loan-backed securitisation market.
- This would permit banks to lend while meeting Basel III capital requirements.
- But changes are needed in the regulatory stance if this is to happen.
- Differentiation between High Quality Securitisations and more risky, less transparent and simple deals is necessary.

Regulatory and Research Background

Research on risk and capital for securitisations:

- This talk draws on an extensive program of research on the risks and appropriate capital treatment of securitisations performed by a group of bank securitisation risk specialists known as the AFA Quant group.
- Comprising securitisation risk experts from more than 20 major international banks, this group has engaged in a series of discussions and exchanges with regulators and central bank officials on the appropriate development of prudential rules for securitisation capital and liquidity.
- This research program was a response to BCBS (2012) issued in December 2012. This document was the first proposal by the Ratings and Securitisation Workstream (RSW) of the Basel Committee on how capital for securitisations held in the banking book should be treated under Basel III.

AFA Quant Work

www.riskcontrollimited.com/insight-category/afa-capital

Response to BCBS Proposals

http://www.bis.org/bcbs

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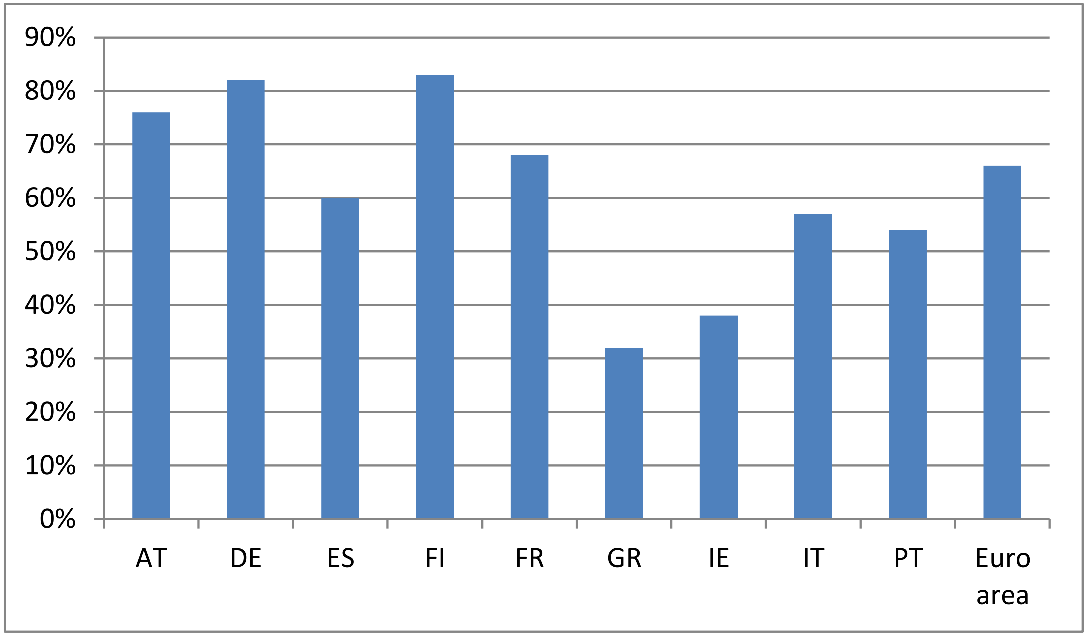
Financing challenges for European SMEs - Access

Loan applicants granted full amount requested



- The figure shows the fraction of SME loan applicants granted their full loan request in different European countries in the second half of 2014.
- The data illustrates the fragmentation of European credit markets created by the sovereign debt crisis.

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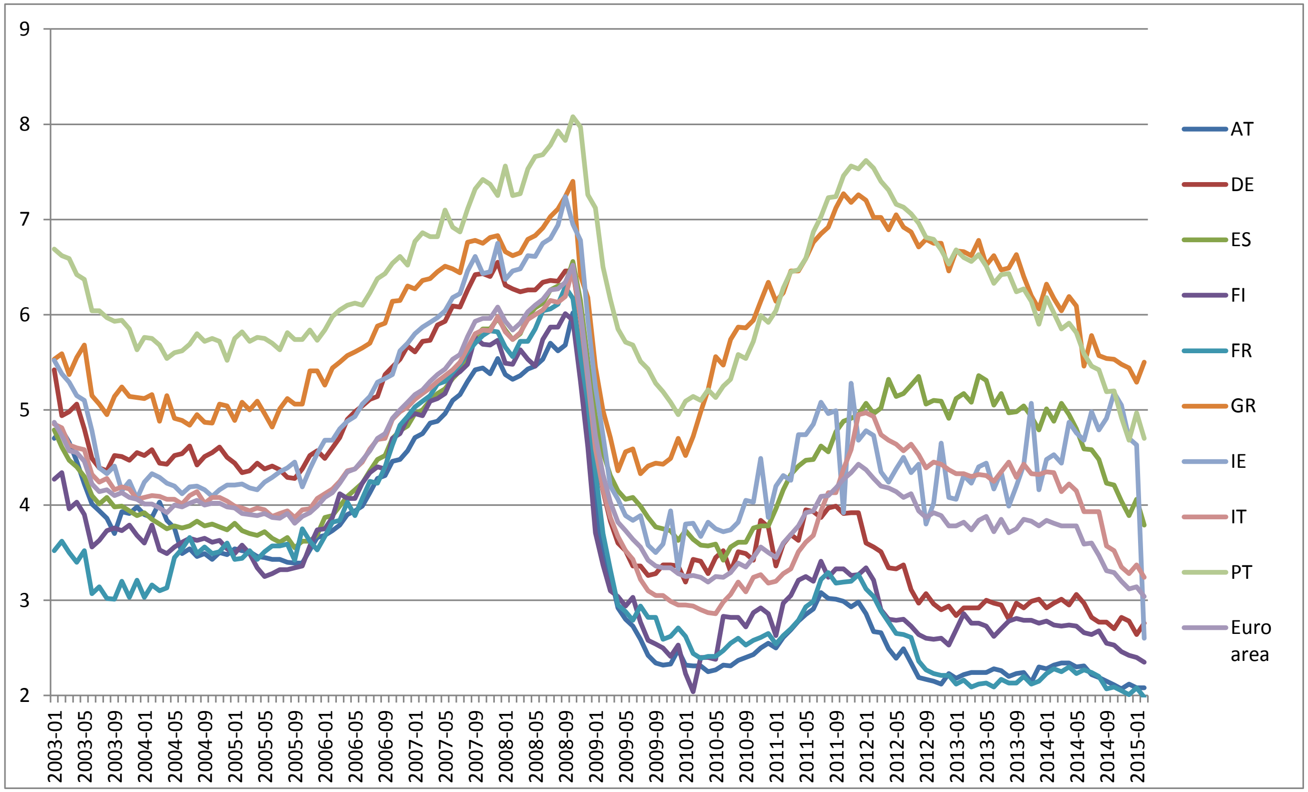
Financing challenges for European SMEs - Rates

Average corporate rates by country



The rates show:

1. the major dislocation created by the Lehman Brothers collapse,
2. the fall in rates as monetary policy loosened,
3. the subsequent rate rise occurring in countries affected by the sovereign debt crisis and
4. the partial, but far from complete, decline in rates in those countries since 2012.

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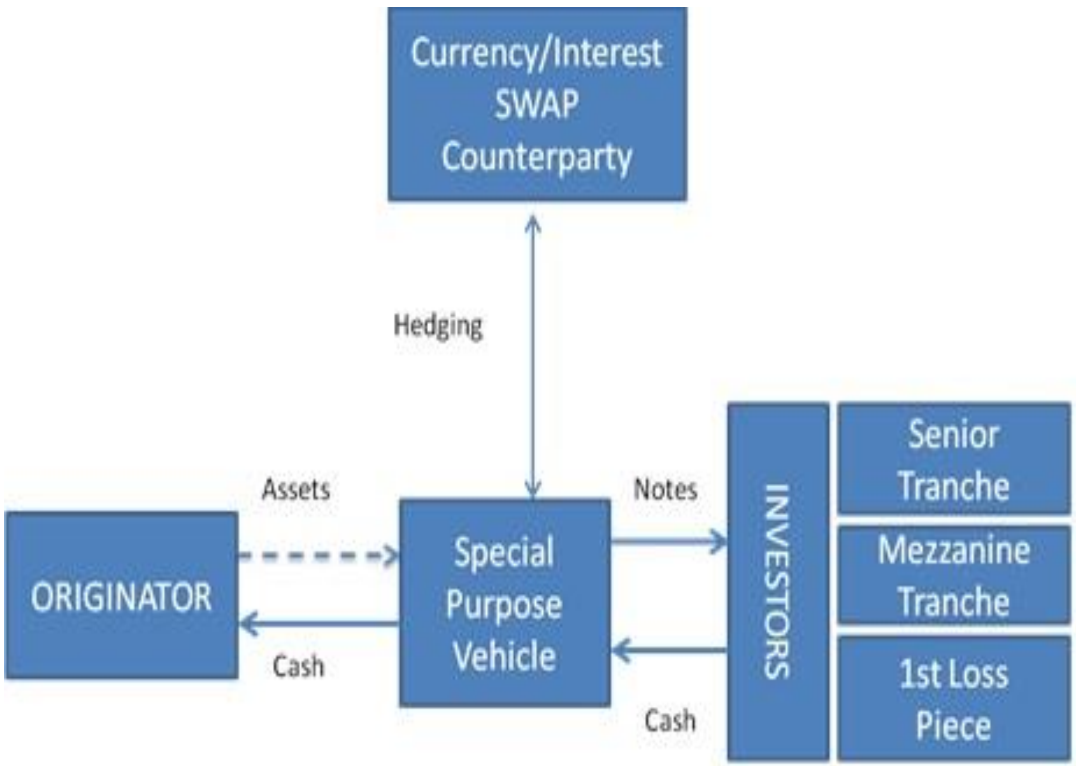
Securitisation as a Partial Solution



- A possible safety valve for the pressures imposed on European banks might be securitisation.
- Prior to the crisis, SME-backed securitisation was the second largest sector by volume (after residential mortgage backed deals) of the European securitisation market.
- Securitisation offers banks the possibility of shifting capital intensive assets such as SME loans off balance sheet.

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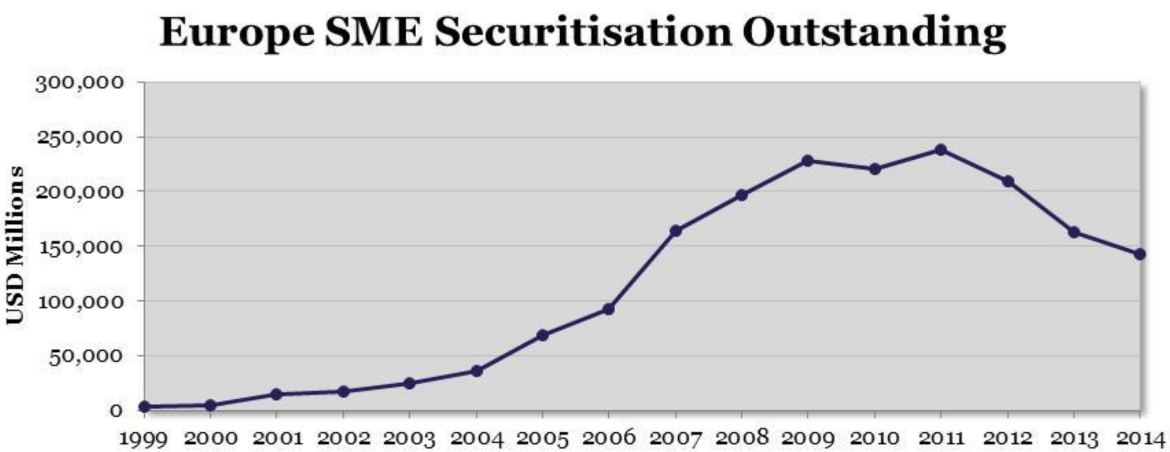
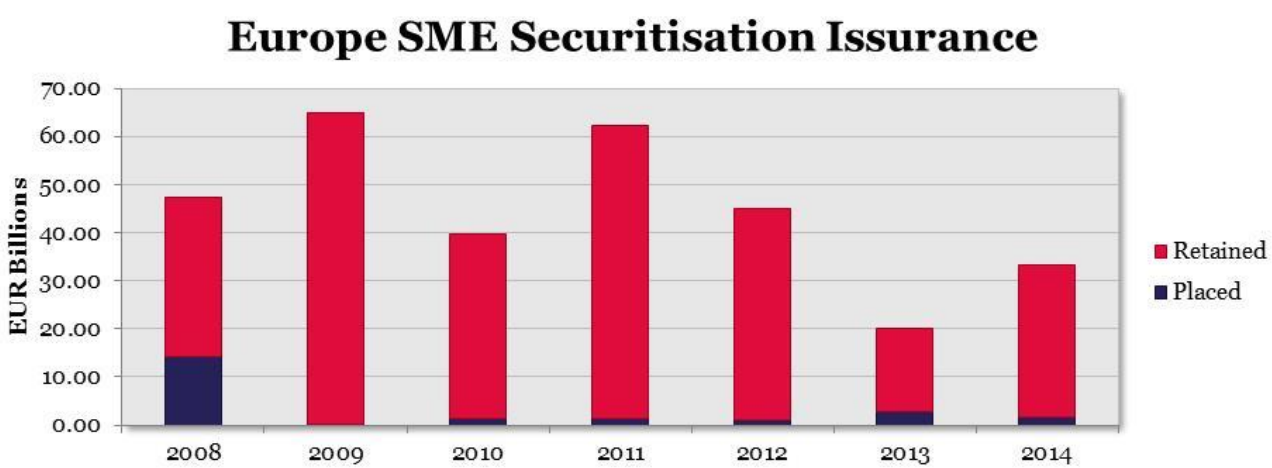
How the European Market Has Performed Since the Crisis

- Since 2007 GDP in countries such as the UK, France, Spain and Italy showed peak to trough GDP declines of 7.2%, 4.4%, 5.0%, and 7.2% respectively .
- Yet, European securitisations exhibited default rates of 2.5% between 2007 and 2013.
- This contrasted with outcomes in the United States where GDP declined by 4.3% peak to trough but US securitisations experienced default rates of 18.4%.
- A large fraction of the defaults that made up the 2.5% for European securitisations was CDOs of ABS, many of which were exposed to US ABS tranches.
- Leaving out CDOs of ABS, the default rate was 1.8%. Also removing CMBS and other CDOs (including synthetic), the default rate drops to 0.12%.
- Retail and Small and Medium Enterprises (SME) loan backed securitisations in Europe proved strikingly robust to the crisis.
- RMBS, Other Consumer Asset Backed Securities (ABS), Credit Card ABS and SME CLOs experienced cumulative default rates of 0.10%, 0.13%, 0.00% and 0.41% respectively between 2007 and 2013.

But Now the Market is Stalled





- Volumes continued to rise post the crisis before declining from 2011 onwards.
- But almost all recent ne issuance has been aimed at securing funding from central banks.
- The volumes placed with investors have been tiny.

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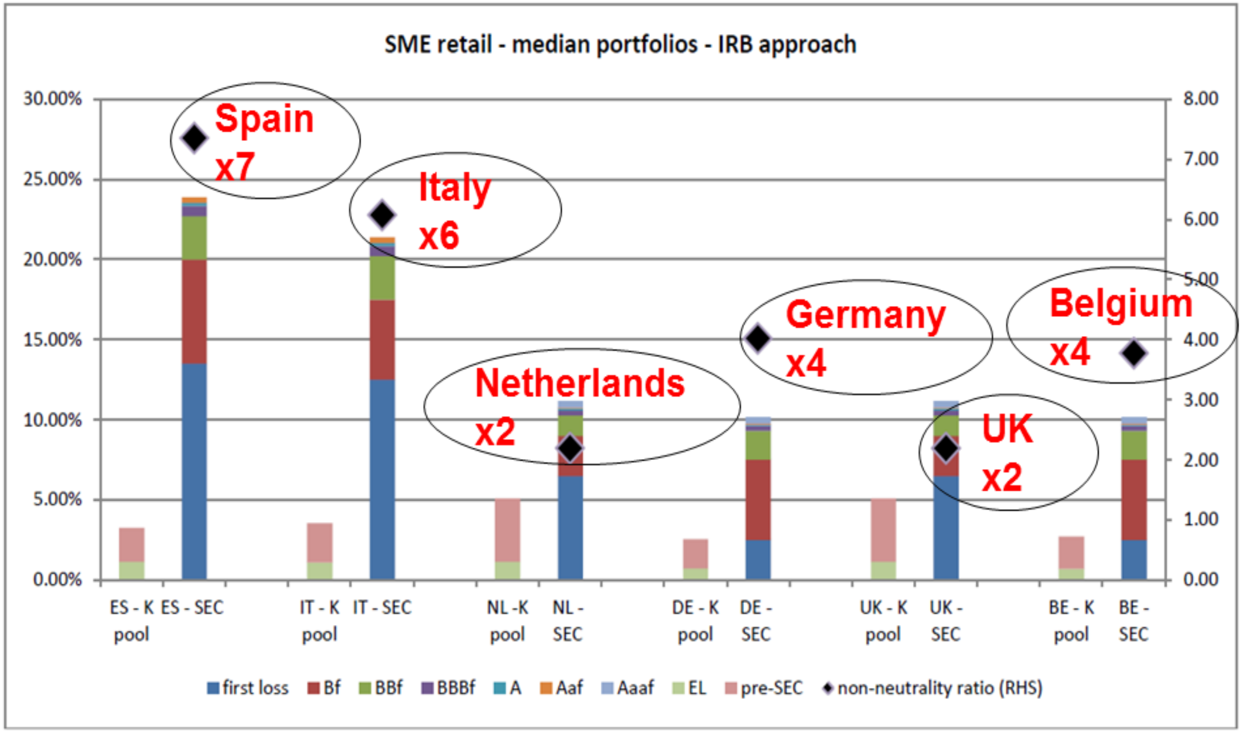
Obstacles to the revival of SME securitisation

The recent EBA Discussion Paper on Simple, Standard and Transparent Securitisations (SSTS) lists impediments to the general revival of the market.

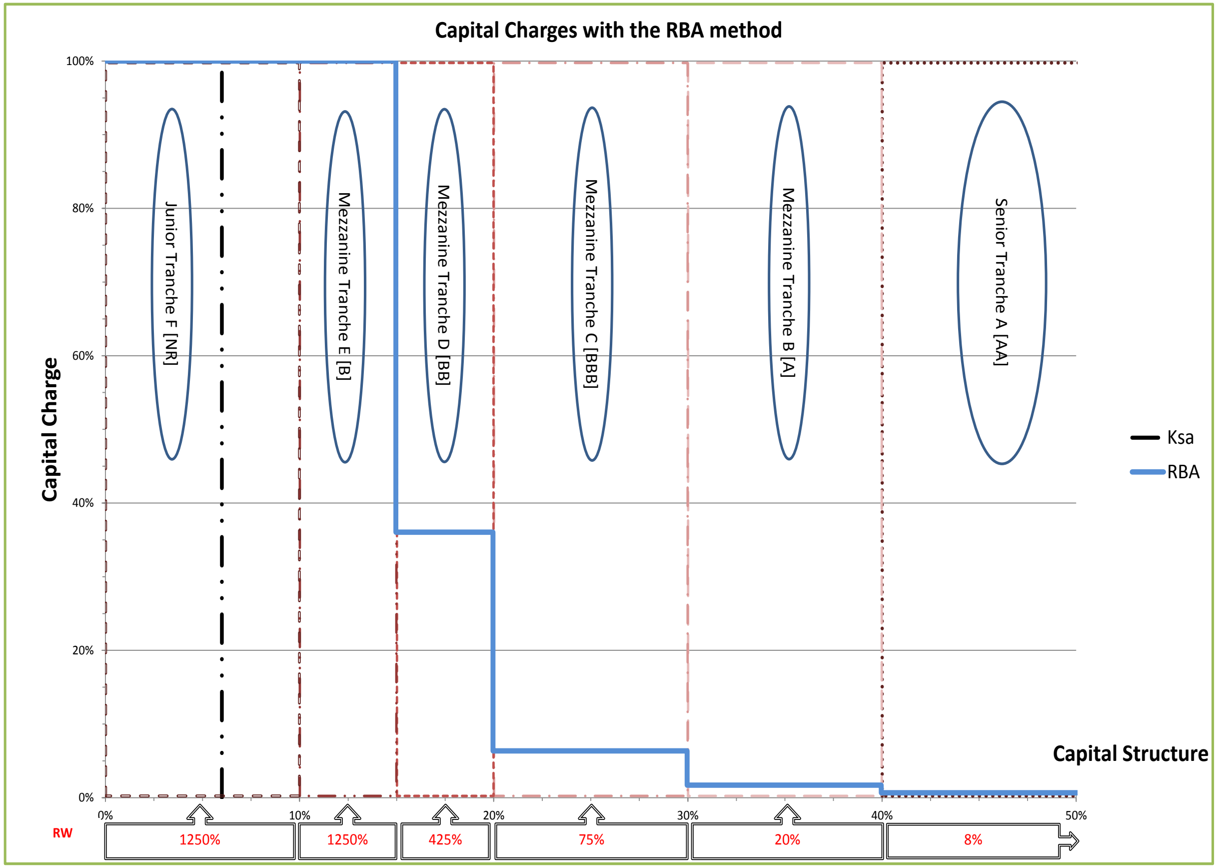
i. The post-crisis stigma attached to the whole securitisation market by investors;
ii. The impact of the macro-economic environment that has unfolded, in some jurisdictions, since the financial crisis;
iii. The role of alternative funding instruments available to institutions in the EU, particularly the availability of central bank funding as a response to the financial crisis;
iv. The tightening of the main credit rating agencies' rating methodologies and rating policies, affecting the securitisation asset class following the negative experience of securitisation ratings during the crisis;
v. The lack of a sufficient investor base;
vi. The potential regulatory uncertainty for issuers and investors from the numerous not yet finalised regulatory initiatives, both at the EU and global level and, a direct or indirect impact on incentives to securitise and/or invest in securitisations.

Non-neutrality of Basel II Ratings Based Capital



- For each country, the left hand bar shows the sum of pool and capital.
- The right hand bar shows the total capital for tranches having different ratings.
- The ratio of the height of a right hand bar to that of a left hand bar equals the ratio of capital for a bank that holds all the tranches of a deal to that of a bank that hold the pool assets.

Capital for an Italian SME Deal



- The figure presents capital for an Italian retail SME deal with stylized tranching. Tranche capital is the area under the blue line.
- The capital of the pool is the area on the left of the black dotted line.
- By comparing both, the problem for an Italian SME issuer is immediately apparent.
- The total RBA capital is several multiples of pool capital.

The Solution: Capital Rules for HQS and Less Reliance on Ratings

Replace CRR rules with risk weights based on attachment points as multiples of pool capital

CRR 575/2013, Article 261, IRB - Ratings Based Method

Credit Quality Steps	Mapping to External Ratings	Credit Quality Step Risk Weight		
		Senior	Non-Senior and Granular	Non Granular
1	AAA	7%	12%	20%
2	AA+ / AA / AA-	8%	15%	25%
3	A+	10%	18%	35%
4	A	12%	20%	
5	A-	20%	35%	
6	BBB+	35%	50%	
7	BBB	60%	75%	
8	BBB-	100%		
9	BB+	250%		
10	BB	425%		
11	BB-	650%		
All other and unrated	B+ / B / B-	1250%		
	Below B- or unrated			

Proposal for replacing ratings in IRB mode

Sensitivity Steps	Mapping to Pool Capital Multiplier	Sensitivity Step Risk Weight
1 (Floor)	x4.00 and above	7%
2	x3.50 - x4.00	12%
3	x3.00 - x3.50	25%
4	x2.50 - x3.00	55%
5	x2.00 - x2.50	110%
6	x1.75 - x2.00	185%
7	x1.50 - x1.75	280%
8	x1.25 - x1.50	400%
9	x1.00 - x1.25	535%
10	x0.75 - x1.00	700%
11	x0.50 - x0.75	900%
12	x0.25 - x0.50	1100%
13	x0.00 - x0.25	1250%

- In practice current European rules in CRR oblige bank investors and originators to use the tranche's external rating to calculate the risk weight of a tranche. Below the IRB table mapping to external ratings
- Mapping to tranche external ratings can be replaced with a mapping based on the risk of the tranche, when a tranche is expressed as pool capital multiple

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Conclusion

The needs of the European economy:

- The European economy remains fragile because pressure on banks prevents a resumption of normal lending activity.
- ECB actions solve the funding problem for banks but not the shortage of capital they face as Basel III provisions progressively come into force
- SMEs lending particularly under pressure because this attracts relatively high risk weights under Basel

Securitisation as part of the solution:

- Securitisation could assist banks to lend to SMEs in a period of capital stringency
- But the market is dead because of current ratings-based capital rules and even tougher Basel III rules in prospect

Nothing will change without policy action:

- The problem could be solved by differentiating in regulation between High Quality Securitisation and the riskier part of the market.
- It is important also to reduce reliance in the capital rules on agency ratings
- We propose simple changes in the CRR that could achieve these goals
- Our proposals are based on an extensive body of research completed by quants from a group of major banks

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Contact

Website: www.riskcontrollimited.com
Telephone: +44 20 3307 0730
Address: 13-14 Dean Street, London, W1D 3RS, U.K.

William Perraudin, Director
Telephone: +44 20 3307 0731 (o) +44 7968 328 459 (m)
Email: *william.perraudin@riskcontrollimited.com*