Enterprise publications

Roundtable between bankers and SMEs

SME Securistisation

Final report

EUROPEAN COMMISSION

CONTENTS

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EXECUTIVE SUMMARY

Securitisation is part of a highly dynamic change in the European banking landscape

Since the creation of the Euro currency area at the latest, the European banking landscape and capital markets have experienced major changes. This highly dynamic development is reflected in the double digit growth rates of the European securitisation markets. Securitisation is an important source of financing and risk transfer; and nowadays is gaining attractiveness as a part of a new business model for banks. As the shift in European banking to more capital-market based lending leads to a close link between primary markets (lending) and secondary markets (where loans are traded), it can have a beneficial impact on small- and medium-sized enterprise (SME) financing.

Effects on risk bearing capacity

Securitisation is the transfer of a portfolio of assets from a bank – or any other financial institution or corporate – to the capital market. In the process of securitisation illiquid assets or claims are transformed into securities (bonds, notes) which can be sold and traded in capital markets. Securitised assets can be all types of assets with a predictable cash flow such as credit card receivables, mortgage loans, car loans, student loans among others. Securitisation works like an insurance for loans, as the credit exposure - which is attached to every loan a bank originates – or the entire loan portfolio is transferred from a bank to an investor. The bank has to pay the investor a fee for the protection, and in case of default the investor pays the loss. Thus, by securitising, the bank transfers the credit risk, which increases its risk bearing capacity and hence its lending capacity. Via securitisation a whole portfolio of loans is transferred/covered. Furthermore, tradable securities (called asset-backed securities) are created, which form a direct link between loan markets and capital markets. Thus, the absorption capacity of the capital markets can be utilised in a securitisation transaction, allowing for the risk to be spread over a large number of operators.

Securitisation should be seen against the background of the changing risk perception and an increasing awareness of the risk involved in lending by banks. While traditionally banks have kept loans in their balance sheet until maturity, they nowadays to an increasing degree actively manage their balance sheet. Depending on the bank's business model and availability of capital or deposits, a transfer of credit to the capital market might be of interest to the bank. At the time of granting the loan, banks do not only aim at achieving risk-adjusted margins, but also provide for the possibility not to keep these loans until final maturity. For that reason, loans are structured in a way that the credit risk can be transferred to capital markets. The trend to increased risk sensitivity of banks is also driven by the introduction of Basel II/Capital Requirements Directive (CRD).

Securitisation can improve the access to finance for SMEs

The increasing interaction between loan and capital markets offers opportunities for European SMEs. In the past, the capital basis of banks limited the loan volume that could be granted. The use of securitisation gives banks the opportunity to extend their relationships to customers independently of balance sheet constraints and to use their credit expertise more intensively. In addition, they can achieve a better diversified portfolio and hence reduce the risk.

Another potential benefit of securitisation is a less cyclical lending behaviour of banks. In an economic downturn banks, when being confronted with rising capital requirements and write-offs, reduce the supply of loans. For certain client groups, access to finance might become very difficult, even if they were prepared to pay higher risk premiums. This pro-cyclical relationship between economic cycles and loan supply is expected to increase due to the implementation of Basel II. A securitisation strategy might limit the negative impacts on loan supply.

A third advantage is an increasing range of available financial products to SMEs. In some countries, via securitisation, banks started to offer riskier products like subordinated loans and participation rights. By using securitisation, these banks are able to transfer the credit exposure to investors.

Securitisation does not alter loan conditions and servicing standards

Securitisation usually implies the selling of the loans to a third party, and borrowers are of course interested not to be negatively affected by such transfer in ownership. If a loan is securitised, the servicing of the loans remains with the bank, i.e. the client does not notice or suffer any changes and the customer relationship is preserved. The loan agreement between the bank and the client remains in full force. Furthermore, the rights of the borrower are protected by appropriate techniques and in most cases the name of the borrowers is not given to the investors. Thus, investors do not possess direct access to the loans.

Securitisation of SME loans is lagging behind due to market imperfections

Even though SME securitisation has become more wide-spread in the EU, the market is still immature and does not reach its full potential to provide additional access to finance for SME. This holds in particular true in comparison to other sectors, such as mortgages where securitisation enabled banks to increase the production of mortgage loans and increased the affordability of mortgage loans even to "problematic" groups with low income or impaired credit history.

There is a wide range of reasons why the SME-securitisation market is developing slower than other market segments. This is to a large extent linked to the high degree of diversity in loan instruments available to SMEs, the different types of collateral and different legal forms of SMEs. In addition, securitisation of SME loans implies high market entry costs, which affect in particular regional banks or smaller credit institutions which often have a high market share in the overall SME-lending.

Public support

Several policy interventions at national and EU-level have been started to accelerate market development which is perceived as too slow due to market imperfections. Public support – although using different instruments – in each case focuses on the erosion of barriers caused by market imperfections. Some programs have been in place since the start of the millennium. Public support has given an important impetus to the development of the SME securitisation market and thus has helped to secure and/or to improve the access to finance for SMEs in a rapidly changing environment. It is further noteworthy that all instruments or programs run very cost-efficiently, i.e. with a low degree of intervention (often at market prices), and promotional effects for SMEs can be assumed.

The Round Table discussions have identified the following key areas for action to develop the market for SME loan securitisation:

- Public support for SME loan securitisation must be made conditional on ensuring 'additionality' i.e. extending new loans to SMEs so that SMEs profit from the support given to the transaction. The securitisation window of the CIP financial instruments offers a good example of such an approach. Member States are encouraged to adopt similar schemes and consider the general guidelines outlined in this report.

- Public programs should have sufficient size to foster market growth. They should work with the private sector and avoid distorting the market. In particular they should focus
    - on helping to extend the market to smaller and lower rated SMEs;
    - on helping to broaden the range of financial instruments which can be securitised: with special regard to mezzanine finance as it can strengthen the equity ratio of SMEs; and
    - on assisting regionally active or smaller banks to get access to securitisation.

- Member States are invited to evaluate whether their regulatory frameworks hinder the development of SME loan securitisation markets. Equally the Commission and Member States should work together to identify barriers that hinder cross-border securitisation transactions.

- Financial institutions serving SMEs should consider whether they could make use of the securitisation techniques to reach a broader range of SMEs.

- Banks and banking associations and national accountancy bodies should consider increasing their efforts to better explain to SME organisations the benefits of securitisation. Transparency and dialogue between the parties is crucial to facilitate the growth of this market.

- The European Commission is invited to promote the exchange of views among banks and their associations, SME organisations and policy-makers on the effects of securitisation on SMEs. The Commission is also invited to consider the setting-up of an expert group to broaden expertise in securitisation techniques among banks and interested public authorities.

1. SECURITISATION: TECHNIQUE, MARKET AND KEY PLAYERS

Securitisation is the transfer of a portfolio of assets from a bank – or any other financial institution or corporate – to the capital market. In the process of securitisation illiquid assets or claims are transformed into securities (bonds, notes) which can be sold and traded in capital markets. Securitised assets can be all types of assets with a predictable cash flow, such as credit card receivables, mortgage loans, car loans, student loans, etc. In the following, we will focus on the securitisation of SME loans.[1] By transferring SME loans to investors, banks can realise several objectives, the most important ones are risk transfer and new funding. Before discussing the objectives at full length, the technique will be briefly explained. Technical details with an example for illustration purposes will be presented in Annex 2.[2]

It is the objective of this report to describe the development of the European SME securitisation market, its driving forces and its consequences for SME financing. A key topic is to show how SMEs can profit from the potential benefits securitisation offers and to analyse the role public support could play to foster the development.

1.1. Technique

Securitisation begins when a bank selects a suitable pool of SMEs loans to be securitised. The portfolio – often comprising several hundred or thousand small loans – is sold in a second step to an insolvency remote special purpose vehicle (SPV) specially founded for this transaction. The bank or seller of the portfolio is called the originator. In order to finance the purchase of the loan portfolio, the SPV issues bonds or notes on the capital market. These notes are called asset-backed-securities (ABS).

ABS-notes are fully dependent on the performance of the asset portfolio purchased by the SPV and investors of the notes are only "backed" by the incoming cash flows of the loans. These incoming cash flows are allocated to the notes according to an exactly defined priority setting out which among the different investors gets paid first. This priority of payments is called waterfall principle and effectively creates tranches with different risk levels. Each tranche is represented by a special note (class A, class B…) and is characterised by a specific risk-return profile determined by both the performance of the underlying portfolio and the tranche's seniority in the so-called capital structure (see right side of Figure 1).

At the top of the capital structure are low-risk notes (senior notes, AAA rated). They have a fraction of about 80 to 90% of the total portfolio, depending on the quality of the loan pool. In the middle of the capital structure are mezzanine and at the bottom high-risk notes. Incoming cash flows are paid to the most senior tranche (AAA) first and then top-down. The waterfall principle is reversed when it comes to losses: shortfalls in incoming cash flows – mainly due to default of loans contained in the securitised portfolio – hit the most junior tranche or investors respectively first, i.e. losses are allocated bottom-up. Accordingly, the lower-rated junior tranches

[1] In Annex 1, we present the EU definition of SMEs. In addition, it should be pointed out that markets - from time to time - use another definition of SMEs in their daily business.

[2] Several sources provide informative overviews on the securitisation technique. A good introduction is e.g. given by Emre Ergungor (2003): "Securitisation", Federal Reserve Bank of Cleveland, http://www.clevelandfed.org/Research/Com2003/0815.pdf, or: Andreas Jobst (2006): Asset securisation as a risk management and funding tool – What small firms need to know", Managerial Finance, vol. 32, no. 9.

form a protection (a so-called credit enhancement) for the more senior tranches, as investors in higher-rated tranches are protected from losses by more junior tranches which have to cover the first losses. For example, if the junior notes amount to 10% of the nominal pool volume, this junior tranche will bear all losses stemming from defaults on the securitised loans up to 10% of the pool volume. Only if losses exceed this threshold (in our example: 10%), investors in the mezzanine tranche have to bear losses. Therefore, mezzanine investors are protected by the junior note and only run the risk that losses exceed the threshold. The protection by the subordinated junior note is reflected in a better rating of the mezzanine tranche.

Via this tranching technique, it is possible to create very high rated AAA-notes in the portfolio. A rating of "AAA" means that this note is a very secure investment with a very low probability of default. Investors can assume that with a probability of more then 99,9%, no loss on a "AAA"-rated tranche will occur (because the losses hit the junior and mezzanine tranches first). This tranche is therefore as secure as an investment in most government bonds, and it is highly improbable that their investors will miss any of the contractual payments on their notes.

The transaction in principle ends when the loan portfolio is amortized, i.e. when all securitised loans are paid back by the borrowers. The structure of a typical transaction is presented in Figure 1.

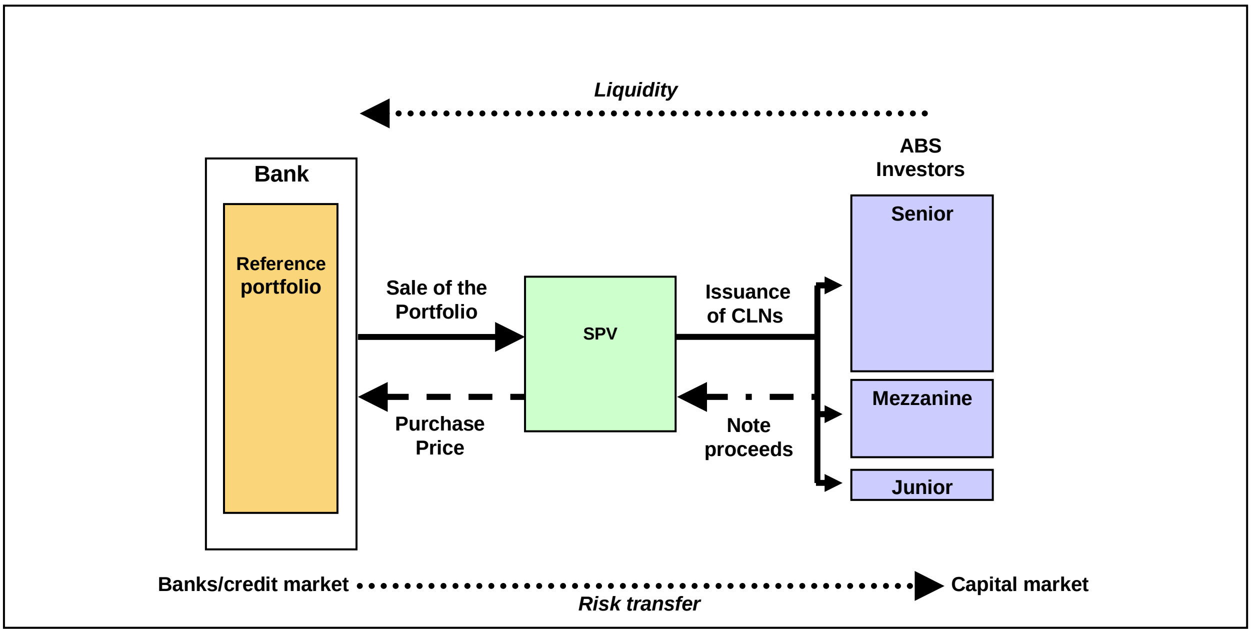

Figure 1: Typical securitisation transactions

Two major securitisation structures can be identified: *true sale securitisation* and *synthetic securitisation.*

- In a true sale transaction a portfolio of assets originated by the financial institution (originator) is "really" sold to the SPV and does not remain on the balance sheet of the originating institution. The SPV issues notes to finance the purchase of the portfolio. Such a transaction is also called "fully funded" as the originator receives funds approximately in the amount of the outstanding portfolio balance.

- The key characteristic of **synthetic transactions** is that the underlying assets remain on the balance sheet of the originator. Only the risk is transferred to capital markets, without transferring the ownership of the underlying asset. Protection is bought by credit derivatives. The protection basically works like a guarantee. Synthetic securitisation is almost always executed via credit default swaps (CDS) or credit-lined notes (CLNs). Like in the true sale transaction structure, the risk transfer occurs also in tranched form, so that the credit risks are distributed among different classes of senior and junior investors.

1.2. Market development

The technique of securitisation was first introduced in US in the 1970s. The European market did not emerge until the early 1990s, but since then has been growing rapidly (Figure 2). 2006 was a record year for European ABS issuance, and the market increased by around 40 %.

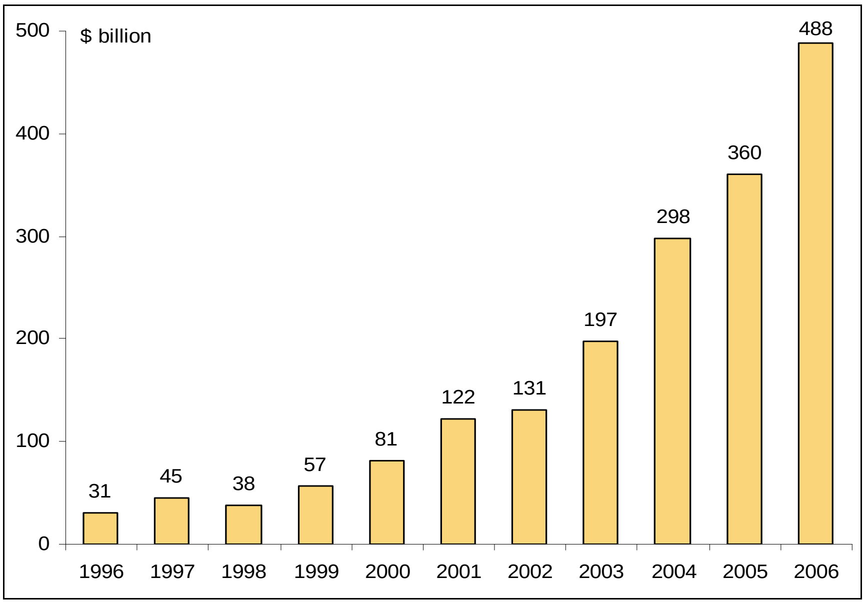

Figure 2: Volume of Asset Backed Securities in Europe, in billion US dollars[3]

As shown in Figure 2, the market growth and the market size are considerable. Both point to a structural change which occurred in the European capital markets. By its size the market is already more important than the corporate and the covered bond markets. Further growth is expected in the coming years. Given the direct link that securitisation constitutes between loan markets and capital markets, the development is also a reflection of a major change in the behaviour of market participants, originators (lenders) and investors.

The securitisation activity in Europe varies considerably from country to country. In 2006 UK showed the highest volume with a share of 39%, followed by Spain (13%). Other important markets are Germany and the Netherlands, both with a market share of 8%.

Nearly 80% of all ABS are bought by European investors. Investors from Asia (5%) and North America (4%) play a subordinated role. Banks[4] are the main investor type. In 2006, they bought

[3] Morgan Stanley Fixed Income Research (December 2006). There is no official market data. Thus, the figures of the market may differ between the reporting banks or market associations. But, all data show the patterns described above of structural change and dynamic growth.

47% of all offered European ABS. Fund managers and insurance or pension funds have a share of 39% together. It is important to point out that the securitisation technique itself prevents investors to have direct access to the securitised SME-loans. Rather, banks and insurance or pension funds use ABS investments to diversify their portfolio and to realise attractive investment opportunities.

1.3. Drivers of growth

Asset-backed securities have become a popular source of financing and risk transfer for a still growing number of banks in Europe within a short time. The growth of the market is a response to changing market forces, regulation and advances in risk techniques and risk management.

On a *macroeconomic level*, the completion of the Euro-zone contributed to the growth of securitisation in Europe. Through the introduction of the Euro, capital markets have become more efficient as the risks of fluctuating exchange rates have been removed and investors nowadays invest more easily in securities in the various Member States. In the new EU Member States, an important driving force is the rapid economic growth combined with a steady credit expansion. Banks need a funding tool to satisfy the expansion of the consumer and commercial credit lending, and maintaining capital requirements becomes difficult when credit is growing at high rates. Securitisation here is a means to support banks to uphold their loan business.

Another driving force was legal improvements in almost all European Member States. Some of them passed special securitisation laws (Italy, Spain, Luxemburg, France) some years ago, while others abolished single legal or tax conditions as did for instance Germany by amending the trade tax to make true sale securitisation of bank loans economically feasible.

On a *meso level,* the dynamic growth of the European ABS-markets reflects changes in the banking landscape. For some years now, a growing number of banks in the EU have been transforming their business model. In line with a more sophisticated risk management, they are increasingly selling credit risks or whole loans to capital markets.

This new banking model is called "buy and sell" loans or credit risks instead of "buy and hold". Traditionally, banks kept the loans until maturity on their balances. The supply of loans was limited by the resources which were available to the banks, i.e. mainly the economic or regulatory capital as a buffer against the credit risk kept on balance. With a "buy and sell" perspective banks can extend more loans – with the same capital basis – to their target groups because they are transferring credit risk and freeing up capital. Banks can employ their capital several times and avoid regional or industry concentration or single borrower concentration. In addition, banks (especially those with a low rating and less favourable funding rates) can combine the capital relief effect with attractive funding.

“Buy-and-sell-banks” utilise - via securitisation - the high absorption capacity of capital markets to be more successful and to extend their business. The potential to securitise seems to be of special relevance for riskier and long term loans which demand from banks long term funding capacity and excess economic capital to support a potentially deteriorating credit quality over the lifetime of the loans.

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[4] Société Générale (2006): ABS Outlook 2007.

The main change in supplying loans occurs when banks just organise the distribution of loans, bundle these loans in a portfolio and directly refinance the loans in the portfolio via a special purpose vehicle in the capital market. These loans are never on the banks' balance although the bank is able to supply its clients with financing. For example, in Germany and some other EU-countries these structures are frequently used to provide mezzanine capital to medium-sized companies.

All these developments can be seen as indicators for the transition towards more capital market based products (see Figure 3). It is important to note that in this process of "disintermediation", the relationship between banks and customers is not hampered, as banks carry on with the distribution and the servicing of the loan.

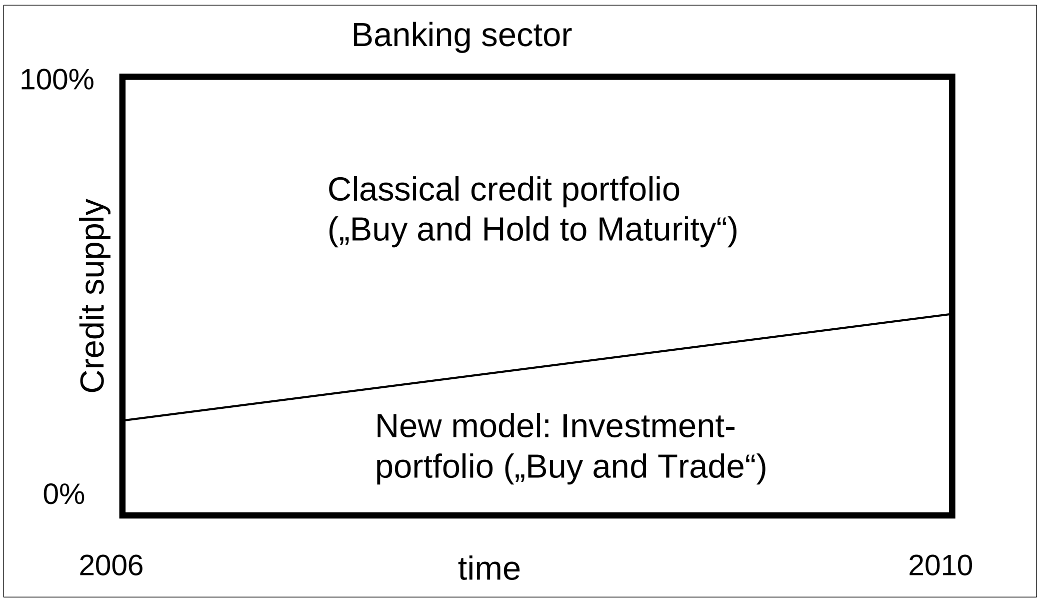

Figure 3: The changes in the European banking sector

The described developments are supported by the introduction of the Basel II/CRD regulations[5], increasing in general the risk sensitivity of the banks. With the full implementation of Basel II/CRD it is expected that loans with a default probability and a rating below investment grade will be costly for banks in terms of risk weight (far above 100%) and regulatory capital.[6] Securitisation might be one important tool to further provide this kind of loans, but also loans with higher risk content like participation rights or equity. Further stimulation is expected due to the specialisation of the banks on certain asset classes and the requirement of risk reallocation to get a stable portfolio.

1.4. Motives of originators

The drivers of two of the key players in the markets, banks and investors are now explained, starting with the perspectives of banks:

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[5] In this report, the new regulatory environment created for EU-banks since the beginning of 2007 is discussed with the heading "Basel II". In the EU, these new rules are implemented via the Capital Requirements Directive.

[6] The report of the AMTE working group provides information on the influence of rating categories on the risk weight for SMEs. Source: AMTE (2006): Supporting SME Financing using Securitisation Techniques.

Access to cheaper and long-term funding
The funding motive is especially important in the case of true sale securitisations when banks receive cash approximately in the amount of the total securitised portfolio.[7] Through the sale of the portfolio, banks get access to an alternative and long term funding. At the same time, they can often reduce their funding costs. To understand why securitisation offers a cheaper funding source than e.g. issuing bonds by the bank in its own name, a look again at Figure 1 and the senior tranche is helpful. As the senior (AAA-) tranche often has a share of about 80 to 90% of the total portfolio, the bank will be able to refinance 80 % to 90% at AAA-conditions. As the rating of the portfolio is usually better than the originator´s own rating, banks can, by using securitisation, refinance on very attractive terms.

Securitisation may also provide "club funding" for smaller banks which have no access to capital market themselves: they can pool their portfolios and achieve capital market funding at competitive rates. In doing so, especially smaller regional banks can provide larger loans without breaching credit policy and concentration restrictions. Securitisation results in a better use of scarce capital resources allocated to SME financing, more profitable SME banking business for the originators, and higher likelihood that funds allocated to SMEs are maintained or even increased.

Efficient risk transfer
In both synthetic and in true sale transactions, risks associated with the loan portfolio are transferred from the balance sheet to the investors. It is an efficient way for banks to manage their loan exposures so as to release economic and regulatory capital.[8] This is particular important in cases where banks possess portfolios with strong geographical or sectoral concentration. The best way to illustrate the process is by an example (see Annex 3, where the consequences of the old and new regulatory framework of Basel I and Basel II are also discussed).

1.5. Motives of investors

The success of ABS is also explained by the attraction they offer to investors worldwide. ABS enjoy, for a wide range of reasons, great popularity. First of all, ABS give investors access to a much wider range of assets which implies better diversification. ABS thereby decrease the risks in their investment portfolio. SME ABS are particular attractive to investors as they show limited correlation with more traditional asset classes on other parts of the financial markets.[9] By buying SME-ABS, investors are able to diversify away from large corporate exposure.
As an investment into a single SME would be very costly and risky for an investor, it is more reasonable for him to invest into a note containing the "pure" risk of a portfolio of SMEs – an opportunity offered by ABS. This note

[7] In contrast, in partially funded synthetic transactions, funding plays a minor role whereas in the case of "pure" synthetic transactions it plays no role at all.
[8] Bank regulation sets a framework on how banks must handle their capital. Under Basel I, banks are required to hold capital equal to 8% of the risk-weighted assets. This is the concept of regulatory capital. Economic capital is the amount of risk capital which a bank needs in order to cover the risks that it is running. Typically, this is calculated by determining the amount of capital that it needs to ensure that it stays solvent at a chosen safety or rating level. Banks should aim to hold capital of an amount equal to economic capital.
The concept of economic capital differs from "regulatory capital" in the sense that "regulatory capital" is the mandatory capital the regulators require to be maintained while economic capital is the best estimate of required capital that banks use internally to manage their own risk.
[9] EIF: "Securitisation as a means to enhance SME financing", http://www.eif.org/attachments/news/news27.pdf

- has the critical size (several million Euros) or volume respectively to justify the transaction costs of the investment,
- is tradable and liquid, so that investors can adjust their portfolio at commensurate transaction costs or can sell the note if they expect a deterioration of credit quality.

An especially attractive feature of ABS is that they are able to satisfy the different risk appetites of investors. Notes are available in all kind of risk categories, ranging from AAA to the very risky first-loss pieces (FLPs). Furthermore, in the past ABS offered better yields than many other assets e.g. AAA rated government debt. This positive attribute of ABS was particular important in the low-yield development we have observed for many years. As the growth of the market shows, a deep and worldwide investor base did develop due to the many advantages of ABS. Banks - which build their business strategy on "buy and sell" or have securitisation in mind when providing loans - can rely on the absorption capacity of the "vast" capital markets. But up to now, not all types of loans are to the same extent integrated in this efficient linkage between loan- and capital markets via securitisation, although the de-linking of loan origination and risk exposure ultimately increases the supply of "tradable" loans by banks.

1.6. Development of SME securitisation market

The ABS-market consists of several market segments. These segments are called asset classes. As an example: All securitisation transactions of residential mortgages build the asset class RMBS (residential mortgage backed securities), and all securitisation transactions in the field of "auto finance" build the asset class "Auto". The longer the asset class exists and the bigger (measured by the number and by the volume of repeated transactions) it is, the more investors get familiar with it. As a consequence, investors are willing to invest at lower risk premiums, which are no longer boosted by safety margins or charges for insufficient liquidity.

Basically, there is the following (simplistic) transmission process:

- For mature ABS-asset classes, the absorption capacity, as measured by volume, is high i.e. a liquid secondary market exists;
- These advantages are, via the "new" business model of the banks, forwarded to borrowers. The supply of bank loans increases along with product diversity.

The stage of market development differs substantially when different asset classes are compared. So far, the European market has been dominated by RMBS (residential mortgage backed securities) with a share of 59% of the European ABS market. CMBS (commercial mortgage backed securities) have a share of 14 % and collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) of 11 % together. In contrast to this, the market share of SME-ABS is only 3%. SME securitisation is thus still of minor importance if compared to other asset classes (see Figure 4).

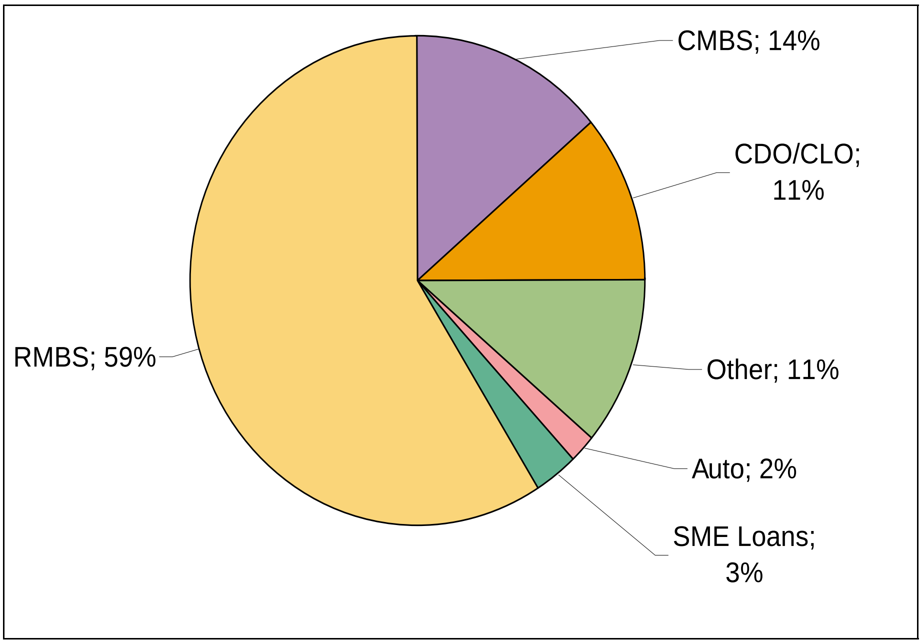

Figure 4: European asset classes (2006) [10]

The volume of SME securitisation is not only small compared to other asset classes but also compared to the total volume of SME loans outstanding. According to a study commissioned by the European Commission[11], it is estimated that only around 1-2% of securitisable SME claims in bank balance sheets have been securitised. In contrast to this, around 10% of the total volume of outstanding residential mortgage loans was securitised in the European Union.[12]

Looking at the share different EU Member States have with respect to the total of SME risk securitised, the market is dominated by Spain and Germany. In 2006, Spain had a share of 37% of all SME risk transferred to the capital market. Germany had a share of 27%. Of minor importance were the Netherlands (19%) and Greece (10%).

All securitisation techniques have the following common characteristics:

- Securitisation is a transformation process by which credit risks are transferred from the loan (primary) market to the capital market by creating tradable securities. This constitutes a direct linkage between primary and secondary markets[13].
- The securities created by the tranching technique have different levels of risk.

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[10] Morgan Stanley Fixed Income Research (December 2006)

11 GBRW (2004): Study on Asset-backed-securities: Impact and use of ABS on SME finance; http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/report_en.pdf

12 The European Commission (2006): "Report of the Mortgage Funding Expert Group", Internal Market and Services DG.

[13] On **primary market**s, banks supply new loans which are demanded by SMEs. As a general rule, bilateral loan agreements with individual criteria are concluded. In contrast to this, on **secondary markets**, existing loans (i.e. loans which have already been supplied) are traded between investors. A prerequisite for a functioning and efficient secondary market is transparency and liquidity.

Securitisation constitutes a direct link between primary markets (where loans are originated) and secondary markets (where existing loans are traded). The considerable growth of ABS markets shows that bank lending is more directly dependent on capital markets than ever.

The volume of loans supplied to SMEs, the range of products and the price at which they are offered nowadays depends narrowly on the ability of the originator to use securitisation. Lower volumes of SME securitisation are therefore a lost opportunity to improve financing conditions for SMEs.

2. SME SECURITISATION

Against the background of changes in the European banking landscape and the increased risk awareness of banks, securitisation of SME loans is an instrument which can lead to a higher supply of SME loans on the primary market. The increased access to finance for SMEs is of course of highest importance.

Securitisation implies the selling of loans to a third party (the SPV). The borrowers of these loans are interested not to be negatively affected by this change in ownership. They fear that loan conditions might be altered and/or the servicing is transferred to an unknown or less dedicated party and/or investors might directly intervene in their company. Improved access to finance in these cases would clearly come with high opportunity costs for the SMEs. If a loan is securitised, neither the name of the borrower is given to investors nor do the investors have direct access to loan details including the collateral. Investors are only backed by the loans sold to the SPV - they do not possess these loans directly and they have no right to enforce into these loans.

The servicing of the loans remains in the hands of the originating bank without any impact on the borrower: the client does not notice or suffer any changes from her bank. The customer relationship is fully preserved. Moreover, in case of restructuring of an SME, the loan can be taken out of the portfolio. In particular, a bank is able to restructure a loan as if his loan has not been securitised. Furthermore, the bank is often allowed to buy back the loan from the SPV (at market prices) or to remove it from the securitised portfolio. Investors are interested in a proper restructuring of a loan to minimize prospective losses out of impaired loans.

Contrary to the approach followed by some private equity funds, ABS investors have no interest and also no possibilities to interfere in the relationship between the SME and the originator. Rather, it is in the investors´ interest that loans are properly serviced by the bank as this ensures better repayment of the loan. To achieve this, at least parts of the first loss piece are retained by the bank. Ideally, neither the customer nor the credit officer should be informed that the loan was securitised. Furthermore, securitisation has so far not been the cause for outsourcing in the servicing of SME-loans. For banks - which have to be competitive in all parts of the value chain of loan production - outsourcing of the whole or parts of the servicing function is a general business decision which is normally taken for a whole business line to exploit economies of scale and is therefore independent of a single securitisation transaction or the sale of certain loans.

The sale of the loans does not alter other loan conditions. For this to happen the prior consent of borrowers is needed. In most jurisdictions it is also the rule that loans to borrowers which are explicitly against the sale of their loan will not enter into securitisation transactions. In some transactions, borrowers consent that their names are made public. In these cases it is in their interest to do so, because they want to get a capital market presence.

The real effects of securitisation to SMEs are all positive and can be divided into three aspects:

- Increase or maintenance of loan supply to SMEs;
- No rationing of loans to SMEs in times of economic downturn;
- Increase in affordable loan products.

2.1 Likely benefits of securitisation on SME-lending

Increased supply of loans:

- *Lifting capital constraints*: By securitising an SME loan portfolio, banks are able to set free capital (as was explained in section 1.4). The released capital can be reemployed for new loans to SMEs. By this, a multiple of loans can be produced with a given capital base. In other words, banks are able to delink their loan origination from the credit exposure they keep on their balance. In doing so, a bank can further extend loans to clients for which it would otherwise run into concentration limits. This holds particularly true for banks which focus their business on a special region and/or loans to SMEs. These banks can extend their relationships to customers independently of balance sheet constraints and they can use their credit expertise more intensively. Often, banks – which enter into the cycle of originating loans and securitising them to free up capital for new business loans - are able to increase their return on equity. The more successful they are in that respect, the more they will be able to expand their SME-business.
- *Lifting the funding constraint:* For many banks securitisation offers - at least for the AAA-part of the securitised portfolio - better funding rates than for the bank with its standalone rating. Via securitisation, better rated banks can diversify their funding sources, especially for long-term funding. This makes them more competitive in SME-lending. In a competitive environment it is the SME which will profit from the optimized funding conditions.
- *Combination:* Securitisation is most powerful if both effects are combined. This is always the case when banks organise the collection of loans for securitisation purposes only. In this case, banks offer a certain financial product, e.g. highly standardised participation rights, to their customers. As soon as the bank has built up a portfolio of these participation rights, it securitises this portfolio and thus does not have to carry any risk exposure. By this, they can provide their clients with new loans (or more sophisticated products) without increasing their credit exposure.

Reduced risk of rationing

- Bank lending tends to behave pro-cyclically. In an economic downturn when banks are facing rising capital requirements and write offs, loan supply may decrease. For some client groups, loans might no longer be available at all, even if they are prepared to pay higher risk premiums. It seems (see Annex 4) that this kind of rationing could be largely mitigated by banks which are following a strategy of "buy and sell" for SME-loans. In recessionary times, they will be able to provide liquidity to their SME-clients as long as these accept to pay higher spreads ("prices") for their loans.
- With the implementation of Basel II, it cannot be excluded that banks, in economic downturns, have to increase their own funds and write offs much faster than in the past. A securitisation strategy may dampen the negative impacts on loan supply.

Broader product range

- Long-term loans need to be financed by long term liquidity. The longer the period the less predictable is the repayment capacity of the borrower. SMEs may suffer a deteriorating credit quality (rating migration) during their long lifetime which will unexpectedly increase capital costs for banks (especially under Basel II). Via securitisation, banks can share these uncertainties with the capital market and are able to offer longer maturities to SMEs.

- In some countries, via securitisation, banks started offering senior unsecured loans, or subordinated loans and participation rights. These instruments in principal bear higher risks, because in case of default of the company, the final loss is expected to be high (due to lower collateralisation and/or subordination). Since securitisation allows the transfer of the credit exposure to investors, banks can increase the supply of these risky products.
- New competitors are able to enter the SME-loan market (also across border) with new products if they can rely on a functioning secondary market. This is for instance the case for mezzanine instruments. For example, a securitisable mezzanine product was created by a Swiss non-bank. Via the banking system this product is nowadays offered to companies in several Member States.
- At least for the larger and better rated part of the SME sector, the securitisation market offers the possibility to sell their trade receivables. Thus these companies get alternative liquidity to bank funding, can reduce their working capital and are able to improve their management of trade finance.

The observation that SME securitisation is favourable to SMEs and could lead to improved access to finance is supported by a study commissioned by the European Commission.[14] The study points out that the beneficial effects of securitisation are not yet fully explored because SME-securitisation did not develop as fast as other market segments. The RMBS market is in that respect an illustrative benchmark: use of RMBS supported the housing boom in Spain and the UK heavily. In addition, access to mortgage products increased, i.e. more loans with high loan-to-value or loans to "problem" groups (low income, people with impaired credit history) were granted.[15]

2.2 Market failures

There is a discrepancy however between the potential of securitisation and the current maturity of the SME-securitisation market. There are several reasons why securitisation in the SME market is developing slower than in other market segments:

- Market imperfections: SME-loans are more heterogeneous than other loan types (residential mortgages, consumer loans). They are also less homogenous than loans or bonds of larger companies which have an external credit rating. For the latter, the securitisation market is well developed, and the available liquidity facilitates the mobilisation of large amounts of funding (for instance for acquisitions).
- Market entry costs: High entry costs mainly affect regional banks or smaller credit institutions that are the main lenders to SMEs.

[14] GBRW (2004): Study on Asset-backed-securities: Impact and use of ABS on SME finance; http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/report_en.pdf

[15] The International Monetary Fund (IMF) also found empirical evidence that securitisation has lead to a steadier supply of mortgage finance and reduced output losses (see Annex 4).

Imperfections
Securitisation produces securities that are sold to capital market investors. These investors are exposed to risks (defaults) of the loans in the securitised portfolio. Compared to the originator (i.e. the banks selling the loans), investors have less information on the quality of the loans. Investors must be convinced that the originator is not selling a bad selection of loans and that there is sufficient reliable data to estimate the expected losses properly. To increase investors' confidence, rating agencies are involved to overcome this situation of asymmetric information between banks and investors. The agencies perform due diligences to review the underwriting and servicing practice, and analyse the historical data on defaults and losses and compare them with their own experience. The less extensive or reliable the information or data are, the higher will be the safety margins that the rating agencies apply in assigning the ratings. This brief description already explains why SME-loans are - due to their large diversity - more difficult to securitize than other loans. To illustrate this, SME-loans comprise:

- Loans to companies of different size, from very small companies with almost no management structures to well organised medium sized companies,
- Loans to companies in different legal forms and with very different collateral (mortgages, machines, private guarantees) attached,
- Senior loans, subordinated loans, overdrafts, trade finance, loans with guarantees etc.,
- Loans amortizing and with bullet structures (i.e. the amount of the loan is paid back at the end of the maturity all at once)
- Short term and long term loans and loans to SMEs from different industries and regions.

In order to be able to securitise this wide range of loans banks must have an extensive data base. This data base is often not available or the required data cannot be extracted from the existing files. To enter the securitisation market successfully, many banks therefore have to invest into their infrastructure, which implies start up costs.

These investments are less problematic for banks which will use the IRB-approach under Basel II. These banks will have internal rating systems for SMEs in place and are required by regulation to improve their data base steadily. They will be better placed to provide investors (via the rating agencies) with the necessary reliable information.

Simultaneously, new originators can profit from the experience the market has made with current or past SME- securitisation transactions. For example, older transactions reveal that the ratings assigned were in some cases too conservative: The realised losses often developed below expectation. Since the market has gained experience, for new originators it should be easier to access the market.

Additional market entry costs
For a bank, it is reasonable to bear the above mentioned start-up costs if it wants to securitise continuously, i.e. if it plans several transactions, or if risk management improves in the run-up of Basel II. A supplementary strategy is to structure new business so that securitisation is made possible.
Apart from the costs associated with the creation of the necessary infrastructure, each transaction causes additional costs. Fees have to be paid to third parties: legal counsel, arranger, rating agencies, trustees, for the SPV and for its management. The fees of the third parties will increase

if the transaction structure or the rating process becomes a complex one. These fix costs demand a transaction size of several hundred millions EURO to be cost efficient.

The size of a portfolio and the robustness of a structure have also implications on the risk premium investors demand. Bigger portfolios are often better diversified, and a well known transaction structure reduces the time and costs investors need to assess the quality of a portfolio. It also prevents investors from the search of a potential "weak link". Standardised structures may in this respect be favourable for many originators, especially first time originators.

The consideration that costs are an important obstacle to securitisation is supported by an empirical survey conducted by AMTE.[16] The AMTE survey showed that for many banks securitisation of SME-loans is too expensive and prevents some originators to use securitisation and to increase SME lending.

The cost components described above explain to a large extent why only a limited number of smaller or regionally active banks have used securitisation so far. Although the risk transfer could be very beneficial, it is the sheer size of their SME-portfolios – often also containing some regional, industry or borrower concentration – which does not allow a more active risk management to increase lending capacity.

There are various measures to overcome these obstacles.

- One is to pool smaller asset portfolios in order to benefit from economies of scale and to make securitisation cost-effective. However, in practice, combining pools of assets is a very difficult process. An intermediary bank might be needed which fulfils a warehousing function.
- Another measure is the use of standardised transaction structures to limit or even reduce costs of third parties.
- A third measure is to reduce costs by standardising loans. A higher degree of standardisation contributes to a better pricing of the transaction and therefore reduces the costs for the risk transfer. SMEs will ultimately profit by paying less for their loans.

2.3 Standardisation of loans

Standardisation of the small loans in the first place helps to reduce administrative costs and makes these loans affordable for small companies. In general, the trend is that companies can choose between "cheaper" standardised loans on the one hand, and more expensive tailor-made loans on the other hand. In the long run small companies will mainly be provided with standardised loans.

Standardisation of loans is helpful for securitisation by making cash flows better predictable, i.e. it reduces the imperfections associated with the diversity in the SME – loans mentioned above. This can contribute to a better tranching of securitisation transactions so that the costs paid for the risk transfer in the capital market will become lower. Ultimately, from this effect small

[16]A survey conducted by AMTE (Euro Debt Market Association) was able to confirm that costs contribute to the low issuance volumes of SME securitisation. In the survey, 57 % of all answering banks value the costs of securitisation as too high, and only 16 % regarded the cost argument as of minor importance. A particularly important result was that four out of five banks would expand their lending if they could transfer risk more cost-efficiently. Obviously, for some banks, securitisation of SME-loans is too expensive which prevents them from securitising and increasing SME lending.

companies will profit by paying lower risk premiums on their future loans. Sometimes banks will only provide loans to certain small clients if they are sure that these standardised loans are securitisable.

Securitisation and standardised loans together will help to reduce the spreads charged to small companies because of lower administrative costs and lower risk costs. Contrary to this, flexible or customized loans will be more expensive from both sides, and therefore the benefits of customizing must outweigh this double cost effect.

Securitisation has shown to have the capacity to efficiently enhance SME-access to finance. Securitisation can increase or maintain the loan supply to SMEs, it can prevent rationing in times of economic downturns and it can lead to an increase in the range of financial instruments. At the same time, SMEs do not have to fear that they are negatively affected by the change in ownership as the servicing of the loans remains in the hands of the originating bank. Market failures, which inter alia can be attributed to the heterogeneity of SME loans, explain the slow development of the SME market. Here, public support can help to promote the development of SME securitisation.

3. PUBLIC SUPPORT PROGRAMMES FOR SME SECURITISATION

Several policy interventions on a national and on an EU-level have been started to accelerate the market development which was perceived as too slow due to market imperfections. Public support – although using different instruments – focuses in each case on the erosion of the barriers caused by market imperfections. Some programs have been in place since the start of the millennium. This chapter briefly comments selected public programmes.

At least two reports have confirmed that public sector activity has been successful in stimulating SME securitisation.[17] The Global Financial Stability Report 2004, published by the IMF [18], also came to the conclusion that structural initiatives, started in some European Countries, have been helpful to develop the market. A closer view on European SME securitisation reveals that SME securitisation markets are furthest progressed in those countries where public programs are in place. In Spain and Germany, the Spanish Treasury and KfW[19] respectively, have been supporting SME securitisation for many years now and it is here where the highest issuance volumes can be found.

It can be observed that SME securitisation is lagging behind most other asset classes, which developed very successfully without public support. This applies in comparison to the asset classes of residential mortgages, commercial mortgages, auto loans, consumer loans, credit card receivables and even loans to corporate enterprises. The fact that nearly all asset classes except SMEs are developing rapidly can be viewed as a clear sign that the securitisation SME-loans is hampered by market imperfections. Given these imperfections, the following general guidelines for public support are worth considering:

- Market creation - or a faster development of the market - should be achieved with the lowest degree of intervention. The price building process should not be distorted. Preferably, support to the secondary market for SME loans should be achieved by intervening at market prices if for instance private investors are not sufficiently inclined to take risks in this market segment.
- The market cannot be built if public support is not maintained for a longer period. Public support should nevertheless be reduced step by step if the market starts to get sufficient momentum.
- To ensure that these instruments increase the supply of finance to SMEs, an aid element should be made conditional on the bank ensuring 'additionality' i.e. extending new loans to SMEs so that SMEs directly profit from the support given to the transaction. In these and other cases the maturing market is itself a strong incentive to increase lending to SMEs. The link between public support and loan supply is most straight in transactions in which new loans are almost immediately securitised after origination (and after a limited ramp-up phase). In these cases, banks only hand out loans because they have securitisation in mind, and the degree of additionality is hundred percent.

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[17] The survey conducted by AMTE and GBRW (2004): Study on Asset-backed-securities: Impact and use of ABS on SME finance; http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/report_en.pdf

[18] http://www.imf.org/external/pubs/ft/GFSR/2004/02/pdf/chp2.pdf

[19] KfW-banking group is a public promotional bank in Germany.

From these guidelines, the following instruments of public support can be derived. Several have already been used at European or national level (see the examples at the end of this chapter). Public support could act in various forms - as a dedicated investor, as a standardised platform provider or via government wrapped (guaranteed) tranches.

a) Public support can act as a risk taker

This is done either by guaranteeing or buying certain tranches of a securitisation transaction. In principle all tranches of the capital structure can be guaranteed, i.e. from the AAA-tranche down to the junior tranches. Using guarantees is helpful when a transaction - due to its novelty, small size or complexity - is treated with reserve by key market players. In these cases, where market gaps cause significant pricing and liquidity barriers, public risk taking (at market prices) makes a transaction in the first place possible as public support comforts other market participants, and the public investor acts as a catalyst for other investors. Another positive side-effect is that investors become familiar with the supported asset class and will buy it - in the future - even without guarantees. Furthermore, investors will, when the market matures, buy SME-ABS at lower risk premiums, because liquidity increases and safety margins decrease. This has also beneficial effects on SME financing: The cheaper the transfer of risk to the capital market is for the bank (on the secondary market), the better are the loan conditions (on the primary market).

The instrument of a partial guarantee is also helpful, whereby special risk, for instance country risk, is assumed to make a transaction internationally marketable. In general, the instrument of a guarantee clearly addresses market imperfections stemming from asymmetric information between originators and investors about the quality of the loan portfolio.

b) Standardisation of structures

By repeated action or by building standardised platforms, public support promotes the standardisation of transaction structures to a certain extent. This reduces transaction and entry costs for originators. At the same time, brand names are created which have positive synergies (i.e. mainly a broad investor base) for all platform users. This is especially helpful for smaller originators (banks) or if innovative financial instruments are securitised. Some of these platforms are open for all banks within the EU as long as the transaction fits into the structure.

c) Application of securitisation structures for new SME lending

Securitisation can be exploited as an instrument by which originators are required to reinvest funds obtained by the securitisation into new loans to SMEs. This approach can, to a varying in degree, be found in all public support schemes (additionality).

By buying large amounts of the AAA-tranche (at or even below market prices), the originator can be forced to use the obtained funds to supply loans to SMEs at a predefined rate. SMEs directly benefit from the public support through better conditions.

In this context, securitisation is used as a type of secured lending, as the public institution extends its refinancing to banks very active in the field of SME lending. Because of investing in tranches of a transaction and not giving funds to the on-lending bank directly, the public institution is able to channel funds to the on-lending bank even beyond its own internal limits for this particular bank.

Guarantees, supplied at the time the loan is originated, homogenize the collateral attached to loans and improve recovery expectations in the rating process. Both effects make securitisation easier.

Guarantees can be attached to risk tranches in the securitisation operation, thereby contributing to a better tranching. In this context, the public guarantee scheme could be efficiently used to support a much bigger risk transfer and to mobilize funds.

At national level, public support programs run by the Spanish Treasury and by KfW in Germany have to be mentioned. In Italy SME securitisation is supported through 'district bonds'. At European level the EIF is providing support for the securitisation of SME portfolios. (Annex 5 contains a detailed description of these existing programmes.)

Public support although different in nature, has successfully contributed to the development of the SME securitisation market and thus has helped to secure and/or to improve the access to finance for SMEs in a rapidly changing environment. It is further noteworthy that all instruments or programmes run very cost-efficiently, i.e. with a low degree of intervention (often at market prices) which is close to zero, considerable promotional effects for SMEs have been achieved. The maturing of markets needs time and is only achievable in the course of some years.

4. OUTLOOK

In comparison to other asset classes, so far securitisation played a minor role with respect to the supply and pricing of SME loans. Even though SME securitisation develops, as the following trends show, the total market volume and some segments are still behind its full potential to improve the access to finance for SMEs.

- While in the past the underlying loans of SME securitisation were mainly senior secured and/or unsecured loans, nowadays securitised portfolios also comprise subordinated loans, participation rights and acquisition loans or overdrafts; i.e. instruments which are more difficult to handle in the rating process.
- While in the past the securitised pools consisted only of SME-borrowers with an on average rating equivalent of investment grade or close to investment grade (BBB- to BB+); today a growing number of transactions contain a higher share of very small companies with a lower rating.
- Meanwhile the market gathered experience with smaller pools (down to a few hundred million Euro) and with transactions in which several banks participated (so-called multi-seller transactions). Although the number of these transactions is still quite limited, the pooling of SME loans from several member countries (e.g. the transaction "ROOF" in Poland and the Czech Republic, where a common portfolio of SME loans was securitised, see Annex 1) offers new opportunities.
- Some banks have started to operate programs for which they are originating special SME-loans with a view to securitising these loans. These loans are kept by the banks on their balance only for a very short period sufficiently long to ramp a portfolio until its size and diversity is large enough to be securitised. To give a simple and illustrative summary, Figure 5 shows where the market stands and which gaps remain to be filled with respect to the securitisation of SME portfolios. The figure also shows the progress of SME securitisation when different financial instruments are considered and a further distinction by size class as well as between better- and lower-rated companies (investment versus non-investment grade) is drawn. What can be learned is that size and rating, both frequently intertwined, are the two most important factors of influence which determine whether a certain company can benefit from a particular securitisation program or not.

Looking at first at investment grade companies only, the figure shows that senior loans can be securitized to 100 %. Larger SMEs also have access to all other financial instruments. The coverage ratio becomes lower when smaller SMEs (measured here in turnover) are considered. This holds in particular true for more advanced financial instruments like debt obligations or participation rights. In these cases, it is the small size of the financial need of the company which causes high transaction costs and thus makes it unattractive for banks.

Besides size, the rating of the SME is of major importance. Loans to non-investment grade rated companies are in general more difficult to securitise. Nevertheless, the coverage remains quite high as long as companies which are at least BB-rated are treated. But for senior loans to below BB-rated SMEs, the coverage decreases exponentially. The high percentage of senior loans to non-investment grade companies that can be securitised reflects two things: 1.) These loans to non investment-grade companies are often collateralised, thus lowering the loss given default to an extent that they become securitisable. 2.) These loans are often contained in bigger pools to an extent that better rated SMEs form the majority of the portfolio. An originator can thus also fill in lower rated SMEs. Often, the weakening credit quality is correlated with the size of companies, i.e. the smaller the company, the lower the rating. Here, the two factors of influence – small size and low rating – additionally decrease the potential to be suitable for securitisation. For example participation rights (with securitisation in mind) for very small SMEs with a weak rating do not exist.

Another factor to explain this result is the fact that by absolute numbers, the universe of small or micro companies is much wider and diverse than for medium-sized companies. To this extent, the size factor is also a good proxy for indicating that with lower size, market imperfections increase which makes securitisation more difficult.

To summarise: For all kind of financial instruments the general rule applies that the smaller the company, the lower the coverage. Particularly difficult to securitise are more advanced financial instruments like debt obligations, participation rights and trade receivables. The table below gives information on the securitisation of certain SME financial instruments. It has to be pointed out that companies with a turnover of over € 50 million p.a. are not considered SMEs by the European definition (see Annex 1 for details).

Rating Quality of the borrower / *Financial Instrument*	Investment grade			Non-investment grade		
	Turnover > 50 Mio. €	Turnover 10 - 50 Mio. €	Turnover < 10 Mio. €	Turnover > 50 Mio. €	Turnover 10 - 50 Mio. €	Turnover < 10 Mio. €
Senior Loans	100%	100%	100%	75%	50%	50%
Debt obligations*	100%	75%	50%	50%	25%	
Participation rights	100%	75 %		25%		
Trade receivables	100%			50%		

Figure 5: Remaining gaps in the securitisation of SME financial instruments[20]

These gaps are opportunities missed, and which should be exploited for SMEs as they already are for large companies. Under the perspective to improve the access to finance, it is therefore necessary to increasingly cover smaller and lower rated SMEs as well as financing instruments with a higher degree of risk like subordinated loans or participation rights.

SME securitisation is most developed in countries where public sector support exists. The Spanish programme and the German one have so far been quite successful to promote the securitisation of senior loans. The programmes have also succeeded in the securitisation of loans to smaller SMEs and SMEs with non-investment grade rating. For the future, it will thus be necessary to focus public support more closely on the gaps indicated above.

[20] An example of debt obligations are the German "Schuldscheine" which a SME can issue. Features of this instrument are that Schuldscheine are often not collateralized, that financial covenants apply and that the spread follows capital market conditions. For SMEs, these instruments provide additional liquidity. Furthermore, the SME gets familiar with the customs of capital markets. Often discussed examples are the "Mittelstandsbonds" in Austria.

5. RECOMMENDATIONS

The Round Table discussions have identified the following key areas for action to develop the market for SME loan securitisation:

- Public support for SME loan securitisation must be made conditional on ensuring 'additionality' i.e. extending new loans to SMEs so that SMEs profit from the support given to the transaction. The securitisation window of the CIP financial instruments offers a good example of such an approach. Member States are encouraged to adopt similar schemes and consider the general guidelines outlined in this report.

- Public programs should have sufficient size to foster market growth. They should work with the private sector and avoid distorting the market. In particular they should focus
  - on helping to extend the market to smaller and lower rated SMEs;
  - on helping to broaden the range of financial instruments which can be securitised: with special regard to mezzanine finance as it can strengthen the equity ratio of SMEs; and
  - on assisting regionally active or smaller banks to get access to securitisation.

- Member States are invited to evaluate whether their regulatory frameworks hinder the development of SME loan securitisation markets. Equally the Commission and Member States should work together to identify barriers that hinder cross-border securitisation transactions.

- Financial institutions serving SMEs should consider whether they could make use of the securitisation techniques to reach a broader range of SMEs.

- Banks and banking associations and national accountancy bodies should consider increasing their efforts to better explain to SME organisations the benefits of securitisation. Transparency and dialogue between the parties is crucial to facilitate the growth of this market.

- The European Commission is invited to promote the exchange of views among banks and their associations, SME organisations and policy-makers on the effects of securitisation on SMEs. The Commission is also invited to consider the setting-up of an expert group to broaden expertise in securitisation techniques among banks and interested public authorities.

ANNEX 1
EU DEFINITION OF SMES

In the report, SMEs are considered to be companies with less than 250 employees and a turnover of less than € 50 million or a balance sheet total of less than € 43 million. This follows the European definition for the whole sector.

Enterprise category	Headcount	Turnover	or	Balance sheet total
medium-sized	< 250	≤ € 50 million		≤ € 43 million
small	< 50	≤ € 10 million		≤ € 10 million
micro	< 10	≤ € 2 million		≤ € 2 million

Figure 6: EU definition of SMEs

However, the report also takes into account that the definition of the market may not in all cases be congruent to the EU-definition. For instance, from the viewpoint of some banks SMEs with a turnover of up to € 100 million are also defined as SMEs. The following table shows the pool of the Portuguese SME-securitisation transaction (Caravela 2004), differentiated by turnover category. It can be seen that more than 85 % of the securitised loans follow the EU definition. About 15 %, however, have a turnover which exceeds the EU-threshold. The reason for the bank to include bigger SMEs is to achieve a critical mass of the portfolio and a better diversification.

Turnover category	Share (in %)
€ 1.25-7.5 million	39,85%
€ 7.5-50 million	43,05%
€ 50-100 million	9,98%
€ 100-500 million	1,25%
€ 500+ million	5,87%
Total	100,00%

Figure 7: Transaction Caravela 2004 (Portugal)

In this report, all policy recommendations follow the EU definition. Should we follow the more “market-based” view (as for example in chapter 4), it is indicated.

ANNEX 2

SECURITISATION: FREQUENTLY ASKED QUESTIONS

Which loans are eligible for a transaction?

Typically, banks mainly securitise performing loans, i.e. loans free of third party claims and with borrowers who are not insolvent at the time of the transaction. In addition, it is often required that at least one interest payment has been made by the borrower and the amortization has started.

Why is it necessary to have rating agencies?

The SME loans which the bank would like to sell do usually not possess a public credit rating. In the securitisation process, the credit quality of the pool´s obligors and in turn the pool in aggregate has to be evaluated by rating agencies like Moody´s, Fitch or Standard and Poor´s. Often, to increase investors´ confidence, two rating agencies are asked to assess the portfolio, although this increases the costs of the transaction. But why are rating agencies necessary at all? The reason is obvious, as there is a clear conflict of interest in the structure. Whereas the bank would like to keep all its good loans only for itself and to dump its bad loans in the portfolio, investors would prefer a good portfolio quality. But investors cannot verify the quality of the loans being securitized, even in the case a bank promises to securitise only performing loans. This is when the rating agencies come into play. The rating agencies evaluate the portfolio, based on data supplied by the bank and on own historical data of similar assets, and assess the default risk. At the end of the rating process, the portfolio quality is determined.

Why create a special purpose vehicle?

Special purpose vehicles (SPV) are typically founded for each single transaction. For example the SPV can be a trust. The reason for this step is mainly technical. First of all, it is a means to ensure that the securitized loans are separated from the originating bank. This has advantages for the investors. Should the originating bank default, its creditors will not have recourse to the assets in the SPV. The SPV itself follows rules so that it is insolvency remote. It owns the assets while the servicing remains with the originator and secures the investors with the assets it owns.

How is it possible to get "AAA" rated tranches from lower rated loans in a portfolio?

Portfolios of loans can contain individual loans with ratings from AAA down to BB or even B. For these portfolios an expected loss can be estimated, taking into account mainly the default probability of each loan, its prospective recovery rate and the diversification of the portfolio. This expected loss is calculated for the lifetime of the portfolio. Example: For a portfolio of SME-loans a loss of 0.50% each year is expected. The loans in the portfolio are running five years, so that the cumulated expected loss is 2.50% (5x0.50%) of the pool balance. Junior investors take this first loss risk (or the originator keeps it). According to historical experience, a multiple of this cumulated expected loss is determined. It is highly improbable that this multiple will be exceeded by (expected and unexpected) losses even in severe economic times (like great recession). Looking at past deals, for many SME-portfolios it is highly improbable that losses will exceed more than 15 % of the pool balance. This event will only occur with an AAA-probability which is positive but close to zero. If an investor buys this part of the portfolio risk he is running an AAA-risk and the tranche (85% of the pool balance) will be rated by the Rating Agencies with AAA. Portfolios with less diversification or on average lower credit quality will have smaller AAA – tranches.

Example transaction – ROOF CEE 2006-1

1. What are the motives of the originators for the securitisation?

Two retail banks, Raiffeisenbank POLSKA S.A. (Poland) and Raiffeisenbank a.s. (Czech Republic) were the originators in this multiseller transaction. For both banks loans to small and medium sized enterprises (SME) are the most important business area. Raiffeisenbank POLSKA S.A. (Poland) focuses on micro-enterprises and smaller SMEs with an annual turnover between € 0.8 million and € 5 million, while Raiffeisenbank a.s. (Czech Republic) concentrates on "larger" SMEs with an annual turnover above € 8.5 million.

Both institutions were limited in their further credit expansion to SMEs by regulatory capital. Therefore, they decided to securitise parts of their SME portfolios to release regulatory capital. Both institutions had to combine their SME-portfolios in order to reach a sufficient critical volume for a cost efficient securitisation transaction.

2. Characteristics of the SME portfolio

The SME portfolio, which was selected for securitisation, comprises SME loans of both institutions in three currencies (CZK, PLN, EUR) up to a countervalue of € 450 million. Both sub-portfolios reflect the SME business strategy focus of each institution, which means relatively more small and micro loans in the Polish sub-portfolio and "larger" SME loans in the Czech sub-portfolio. Initially, the portfolio comprised approximately 1,250 loans with an average loan size of € 360,000. As the average lifetime of the initial portfolio was relatively short, both institutions were allowed to replenish their sub-portfolios with new eligible SME loans for the next five years. This means that once loans from the initially securitised portfolio are fully repaid, the portfolio can immediately be refilled with new eligible SME loans. Thus, the new SME loans are also protected by the securitisation and do not demand additional regulatory capital. This is an efficient mechanism to sustain new lending.

The rating agency Moody's analysed the portfolio quality of the SME loans and calibrated the data. Based on Moody's analysis the quality of the total portfolio was internally assessed by KfW ("internal mapping") as Baa3 to Ba1, the Polish sub-portfolio Baa2 to Baa3 and the Czech sub-portfolio Baa3 to Ba1. For Moody's it was the first rating transaction for SMEs in Eastern Europe. A challenge in the rating process was to obtain accurate data about the characteristics of the assets or historical performance of the lender's portfolio, especially the reliability and consistency of data, as only limited historical data was available.

3. The securitisation transaction structure

By using bank swaps denominated in Euro, Raiffeisenbank POLSKA S.A. (Poland) and Raiffeisenbank a.s. (Czech Republic) transferred the total credit risk of their SME sub-portfolios to KfW. As an intermediary KfW bundled both sub-portfolios into a "SME reference portfolio" and carried out the structuring of the portfolio.

The tranching of the total "SME reference portfolio" was done as follows (for an illustration please refer to the transaction diagram):

- Senior tranche: € 377.55 million (83.9 %) with an Aaa-Rating.
- Four Mezzanine tranches: € 59.85 million (13.3 %) with ratings from Aaa to Ba3, i.e. 6.0 % (Aaa), 1.7 % (Aa2), 2.8 % (A2) and 2.8 % (Ba2).
- Junior tranche: € 12.6 million (2.8 %) without a rating.

The transaction diagram provides an overview of the securitisation structure. On the left hand side we have the originator's sub-portfolios of SME loans, i.e. the Czech (RBCZ) and Polish (RBPL) "individual reference pools". In the centre of the diagram we have KfW acting as an intermediary, that pools the sub-portfolios into the "SME reference portfolio" plus the "first loss piece". On the right hand side of the diagram we find the investors of the different tranches of the portfolio. As one key result of the securitisation process an illiquid loan portfolio with a rating of Baa3 to Ba1 was converted into tradable securities, of which a major part (84 %) have a triple A rating.
The servicing of the securitised SME loans remained with the originator, i.e. Raiffeisenbank POLSKA S.A. keeps the servicing of the Polish loans and Raiffeisenbank a.s (Czech Republic) keeps the servicing of the Czech loans.

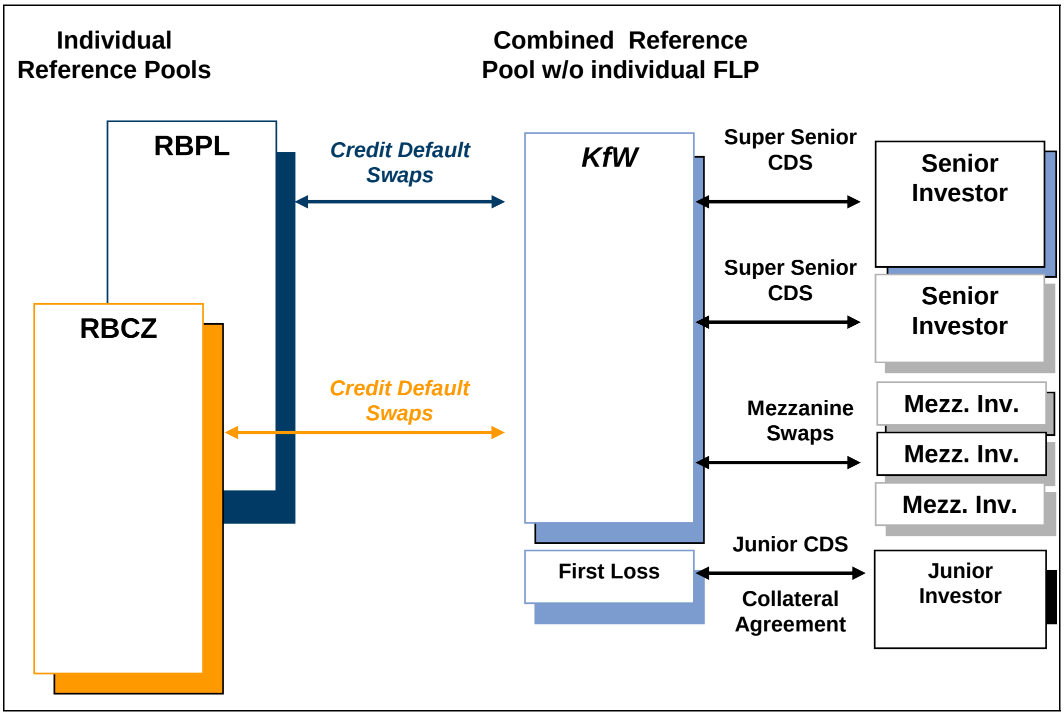

Figure 8: Transaction diagram of ROOF 2006-1

4. Cost efficient transfer of risks

As the sub-portfolios were relatively small a cost efficient transaction structure had to be selected. This was achieved in the following way:

a) The standards of KfW's "PROMISE" securitisation platform were followed to a large extent. The standards of this platform have been tested many times and approved by the rating agencies. This helped to avoid much higher legal costs and costs which result from a more cautious rating of structures which are "untested".

b) A fully "synthetic securitisation" was carried out. In a "synthetic securitisation" (contrary to a "true sale", where the actual portfolio is transferred to the investors), only the credit risks of a portfolio are passed on to the capital market by using credit derivatives (e.g. credit default swaps). A fully synthetic structure is less complicated and therefore more cost efficient than a full structure with notes issuance. Thus the costs of a special purpose vehicle (SPV) and of a public bond offering were avoided.

c) Only one rating agency was involved (Moody's), instead of two.

d) A private placement of risks was chosen, rather than an initial public offering.

e) The arranger, a private bank, was able to work at a fee level commensurate with the "lean" structure.

f) The replenishment potential is also reducing the specific costs.

5. Assessment of the promotional impact

The securitisation transaction ROOF CEE 2006-1 enabled Raiffeisenbank POLSKA S.A. (Poland) and Raiffeisenbank a.s. (Czech Republic) to further extend SME loans to their clients by lifting a regulatory capital constraint. Capital relief in order to reach faster growth of the SME loan portfolio were the main objectives of the originators. Without the successful securitisation both institutions would have been severely restricted in their ongoing business activities with SMEs. In addition the originators could demonstrate with the transaction the quality of their loan portfolio.

ROOF CEE 2006-1 had several innovative features. It was the first synthetic securitisation of SME loans of banks from Central and East Europe. As the banks were relatively small, the loans were diverse and had a weaker quality. The public support by EIF and KfW was essential for the success of the transaction, as the transaction could only be realised in cooperation with EIF and by using KfW's efficient securitisation platform "PROMISE". For KfW it was the first securitisation of SME loans with a multi seller structure in the New Member States. The transaction serves also as a prototype or precedent for further transaction (market creation).

All in all, the transaction was a significant contribution to the development and deepening of the East European SME securitisation markets. In addition the transaction was an important signal for other East and South European countries, as it successfully made evident that it is possible to securitise relatively small portfolios of SME loans which are still considered to be a "difficult asset class".

ANNEX 3

EFFICIENT RISK TRANSFER AND THE REGULATORY FRAMEWORK

Banks must hold a sufficient amount of capital to buffer potential losses which mainly arise due to their typical lending business. If banks calculate the capital needed to absorb losses by their own methods, this amount of capital is called economic capital requirement. In addition, banks are regulated by banking supervisory authorities which require their banks to hold a minimum amount of capital which is called the regulatory capital requirement. The regulatory capital requirement for credit risk was coordinated worldwide within the so- called Basel I capital accord. According to this, banks must hold an average of 8% of capital for loans – measured in risk weights – they extend and hold on balance. Under Basel I, securitisation reduces the regulatory capital requirement if all credit risk is transferred from the bank to (outside) investors. If the bank retains part of the credit risk, it frees up only part of the regulatory capital. The latter case is shown in the example.

Example: Capital relief under Basel I

In below stated example a bank securitises a portfolio of SME loans with an amount of € 450 million. Under the capital requirement of Basel I, the bank needs to hold equity equal to at least € 36 million (8% of € 450 millions). Now, the bank can use securitisation as an instrument to reduce the regulatory capital requirement. Consequently, the bank does not have to hold equity against the loans it *originated* but only against those on which it actually *carries risk*. So, if a bank originates loans and transfers the underlying credit risk to a third party, it frees up capital.

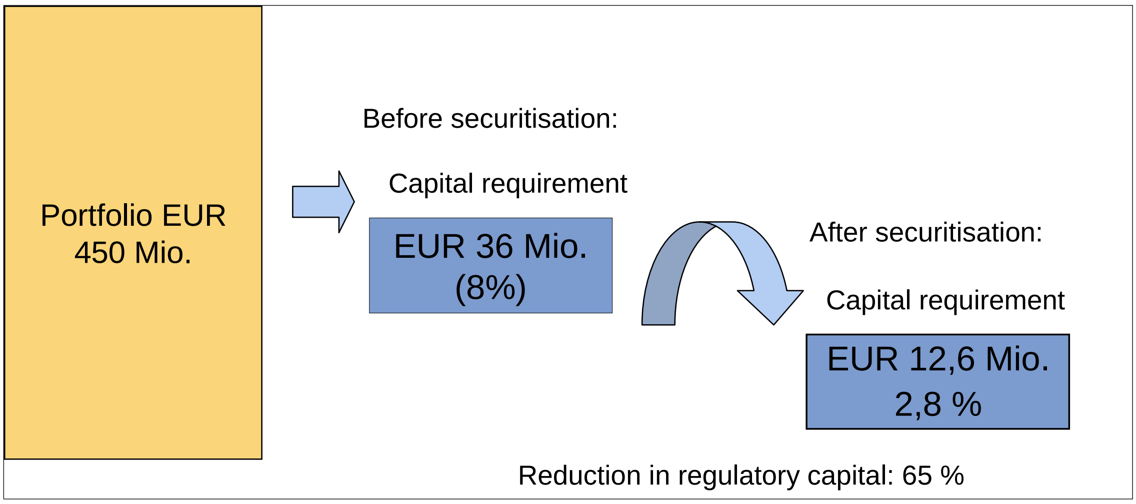

Figure 9: Capital relief in a transaction under Basel I

Here, the required equity is reduced to € 12,6 million, which is a decline in regulatory capital of 65%. The bank would also be able to reduce regulatory capital to € 0 if the total risk of the portfolio had been transferred to the capital market, but in our example the bank retained a first loss piece of € 12,6 million (which covers the first losses from the portfolio). The amount of risk bearing assets was in our example reduced and the savings in capital – € 23,6 million - generate space for new business. The securitisation has thus enabled the bank to grow their SME lending without increasing its capital base: With given equity, more loans to SMEs can be supplied.

Since the beginning of 2007, the banking industry has started to implement the new Basel II accord. The difference to Basel I is basically that the banking authorities tried to bring regulatory and economic capital requirements in line. The risk weights of the different credit exposures nowadays vary according to the default probability or the loss probability respectively. More risky loans will have a higher capital charge than loans with a low loss probability, while under Basel I these loans were treated alike. In this new framework, securitisation in principle has the same impact as under Basel I i.e. it sets free regulatory capital and opens up capacity for new lending.

Under Basel I, there was a clear incentive to securitize loans which were expensive in terms of regulatory capital, i.e. loans for which a capital requirement of 8% was perceived as too high. By securitising these loans, a substantial capital relief was achieved.

Under Basel II, the picture is less clear because capital requirements are now more differentiated as regulators align regulatory requirements more closely to economic requirements.

For SME loans this means

- Loans to SMEs will have a much lower capital requirement than under Basel I as long as the aggregate loan exposure of a bank to the SME does not exceed € 1 million. At the same time, for banks operating under the internal rating based approach (IRB-banks), the capital requirement is much lower than for banks under the standardized approach (standard-banks).
- For loans to SMEs with an annual turnover below € 50 million and with loan exposures exceeding € 1 million, the capital requirement increases in line with turnover until the € 50 million ceiling is reached. Capital requirements also increase when the internal rating deteriorates: IRB-banks are normally required to hold more than 8% capital against loans to SME if the internal rating of these companies drops below investment grade. Standard-banks instead have to hold 8 % capital against loans to these companies irrespective of their credit quality. To summarise: Loans to SMEs with a better internal rating (investment grade) are "cheaper" for IRB-banks than for standard-banks. The picture is different when it comes to loans to lower rated companies. In this case, loans are more expensive for IRB-banks; for banks opting for the standardized approach the capital requirement does not change compared to Basel I (but the bank might anyway be able to better assess the risk and therefore the economic capital needed)
- For IRB-banks and standard-banks, the capital requirement increases substantially if loans to SMEs (irrespective of which rating category) default, i.e. these companies are overdue on payments for more than 90 days or are insolvent. IRB-banks will thus suffer from negative migration effects, i.e. their SME-portfolio is on average deteriorating in credit quality. They will be especially hit if all SMEs in their portfolio migrate towards below investment grade (e.g. in an economic downturn). The same holds true for standard-banks as the risk weight doubles from 75 to 150 % (i.e. the capital requirement rises from 6 to 12 %).

From these observations it follows that:

- Loans to small businesses held by IRB-banks will be mainly securitised to get attractive funding. Capital relief is of secondary importance, but increases in significance if defaults in the portfolio are high and migration effects are strong.
- Loans to small businesses (retail) held by standard-banks will be securitised if standard banks are endangered to become less competitive to IRB-banks. This will happen if the portfolio of standard-banks is of high quality (and if the individual bank decides to stay in the standard approach and not to change to the more favourable IRB approach). Here, too, migration effects and defaults can be mitigated by securitisation or risk transfer.
- Loans to SMEs which are not treatable as retail/small businesses are more likely to be securitised by IRB-banks if their credit quality is below investment grade. The same is true if these loans have a high potential to migrate (during a longer contract period) below investment grade and/or to become low or non-performing. Standard banks might securitize their better part (strong investment grade) of SME-loans to be competitive against IRB-banks. Standard banks are not as much exposed to migration effects but they have to mitigate default effects.

The beginning of 2007 was only the start of the implementation of Basel II/CRD. The full implementation will probably occur in 2010. Until then EU banks are in a transition period. Effectively, IRB-banks have to calculate their capital requirements under Basel I and Basel II. At the same time, the maximal amount of saving in capital requirements of IRB-banks under Basel II is limited: In 2007, the overall capital requirement of an IRB-bank must not fall below 95% of its Basel I capital requirement. In 2008, this floor is 90% and in 2009 it is 80%. In these years, many banks are thus effectively operating mainly in a Basel I environment. Banks also developed transition strategies to profit ideally from the prospective capital savings and/or to avoid the additional capital charges for more risky business. For these strategies, securitisation is also an important instrument.

Due to the transition period and the still unknown number of banks which will sooner or later apply the IRB-approach, the overall impact of Basel II remains difficult to judge. In most of the research done by the banks, securitisation is seen to be of high importance during the transition period, and it is assumed that for assets with high capital charges securitisation will be an important instrument. These riskier assets with high capital charges include certain segments of the SME loan business (e.g. SMEs borrowing more than € 1 million and depending on the individual size and rating; businesses that exceed the € 50 million turnover threshold and therefore are no SMEs according to the new banking regulations; defaulted loans) and all instruments which constitute equity (including some instruments of mezzanine finance) for SMEs.

ANNEX 4

SECURITISATION AND THE PRO-CYCLICAL LENDING BEHAVIOUR OF BANKS

Bank lending responds heavily pro-cyclical, i.e. it declines in economic downturns and rises in upturns. One reason for this can be ascribed to reduced investment spending by companies, which causes a lower demand for loans by the private sector. Simultaneously, on the supply side, banks refrain from extending additional lending to the private sector as a downturn leads to an increase in bad loans, low margins and a heightened degree of risk aversion. Thus, the drop in bank lending in cyclical downturns can be attributed to supply- as well as to demand-side conditions.

Securitisation can help to mitigate these adverse effects. The key point is that securitising banks are able to transfer credit risk to the capital market. Should an economic downturn occur, a decline in the rating of their average portfolio or rising defaults do not affect these banks as they are protected by investors. In this way, securitisation acts as a hedge against deteriorating economic conditions and counteracts a curtailing of the credit supply.

In contrast, banks which do not use securitisation, in recessions face declining margins and have to increase risk provisions. Both effects reduce their overall liquidity and the willingness to supply new loans. It is important to notice that this effect will be intensified when Basel II is implemented, because the capital requirements under this regime show a pro-cyclical behaviour: If the quality of the average portfolio (e.g. the rating of SME loans) deteriorates and a so-called rating drift occurs, banks are required to put more equity aside to fulfil the capital requirements. Should banks run out of equity, they are not able to uphold their credit supply.[21]

Empirical studies in the US, where securitisation markets are much further developed than in Europe, show that the credit supply indeed becomes less sensitive to the banks´ environment as loans became more liquid.[22] The positive effects have been recognized by the IMF: According to the Global Financial Stability Report 2006, securitisation has the ability to promote a less pro-cyclical bank lending behaviour and to result in overall less volatile credit cycles. The IMF found empirical evidence that the credit cycle dynamics have been dampened in the housing sector. In this sector, according to the IMF, liquidity and funding have increased with the greater use of securitisation. Securitisation has been able to lead to a steadier supply of mortgage finance and thus contributed to reduced output losses.[23]

Summarising, securitisation has a positive macroeconomic effect on the stability of the banking system as a rationing on the supply of loans to the private sector can be mitigated. SMEs will particularly benefit from the increased supply of loans as they often are the first candidates - due to their risk profile and on average lower rating quality – who suffer from a rationing in bank lending.

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[21] Results from the Bank Landing Survey, conducted by the ECB, showed that in 2003, restrictions on the balance sheets of banks indeed resulted in a reduced credit supply to SMEs. H.S. Hempell (Deutsche Bundesbank): "Bank Lending Survey des Eurosystems – Erste Ergebnisse für Deutschland" in: „Droht eine Kreditklemme für Deutschland – was sagen die Daten?", Sonderpublikation der KfW Bankengruppe, 2003.

[22] Loutskina, Elena and Phillip Strahan (2006): Securitisation and the Declining Impact of Bank Finance on Loan Supply: Evidence from Mortgage Acceptance Rates. NBER Working Paper Series No. 11983; http://www.nber.org/papers/W11983

[23] IMF Global Financial Stability Report 2006, Chapter 2, http://www.imf.org/External/Pubs/FT/GFSR/2006/01/pdf/chp2.pdf.

ANNEX 5

PUBLIC SUPPORT PROGRAMMES FOR SME SECURITISATION

a) KfW's Promise programme

The German promotional bank KfW Bankengruppe launched its PROMISE Programme in 2000. The programme was a response to the awareness that securitisation of SME loans will improve the access to finance for SMEs. PROMISE was initiated to facilitate the development of a (then virtually non-existent) liquid secondary market for SME credit risk in Germany and to establish German SME loans as an acknowledged asset class.

PROMISE offers banks a standardised structure to securitise their SME loan portfolios. In particular, the program aims

- to ease the capital and funding constraints of the primary lenders
- to encourage banks to use standardised and more efficient origination and loan pricing processes, leading to lower transaction costs
- to reduce market entry barriers for small financial institutions in the securitisation business,
- to attract new investors with previously limited exposures to SME risks.

The PROMISE platform is open to financial institutions from all over Europe. KfW only acts as an intermediary in the securitisation process, i.e. the organisation will not take the economic risk of the underlying SME reference portfolio and will not replace any of the other involved parties.

According to a study commissioned by the European Commission[24], PROMISE has succeeded in raising the profile of the SME asset class in the ABS markets by developing a recognized brand name and structure. Investors have become comfortable with the PROMISE brand and are therefore more willing to assume risk at competitive rates.[25]Owing to its neutrality and its special position within the German banking sector, KfW has assumed the role of an intermediary and has tried to offset market inefficiencies.

b) Spanish FTPYME Scheme

As part of a broader SME support programme (Pequeñas y Medianas Empresas or PYMES), the Spanish Treasury, has supported SME securitisation since 1999. The programme facilitates True Sale transactions and offers guarantees by the Kingdom of Spain with the aim to lower the overall funding costs for the originator. The scheme guarantees up to 80 % of notes rated at least "AA". To qualify for the FTPYME Securitisation Scheme, at least 80% of the pool to be securitised must comprise SME loans. The originator must commit to reinvest 80% of the proceeds obtained from the financing in the SME sector, within the maximun period of one year. The FTPYME program has, besides reduced funding costs, the following positive effects:

- It helps to reduce transaction costs because it has led to a higher standardisation in Spanish SME transactions.

[24] GBRW (2004): Study on Asset-backed-securities: Impact and use of ABS on SME finance; http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/report_en.pdf

[25] ibid

- The regular deal flow has made the asset class of Spanish SME CLOs rather liquid as it has become well known to investors. A higher liquidity means lower spreads.

c) Securitisation in Italy through District Bonds

Italian district bonds are the product of an innovative structured finance technique involving mainly a bank, which originates a series of homogeneous SME loans; credit guarantee consortia, which act as guarantors and collectors of such loans and rating agencies which evaluate the operation's creditworthiness. Once a certain lending volume has been reached, the bank transfers the originated loans to an SPV for their securitisation, while the initial backing provided by the credit guarantee consortia to each single loan becomes an independent form of guarantee towards the entire junior tranche. The structure of a district bond differs considerably from that of an ordinary asset-backed security and can be broken down into 4 stages (Figure 10)

1) The bank promotes a loan origination programme towards SME with similar investment needs and characteristics (SME's participation to the programme is normally endorsed by credit guarantee consortia and industrial associations);

2) Credit guarantee consortia act as guarantors and collectors of the loans granted by the bank, generally up to a maximum agreed amount;

3) Once a certain volume has been reached, the bank transfers the originated loans to an SPV for their securitisation, which can occur almost automatically due to the earlier mentioned homogeneity of the portfolio and the availability of a prospectus containing detailed information on each loan (drafted in accordance with the criteria provided by the rating agencies involved in the operation);

4) The initial backing provided by the credit guarantee consortia to the individual loans becomes an independent form of guarantee towards the entire junior *tranche*.

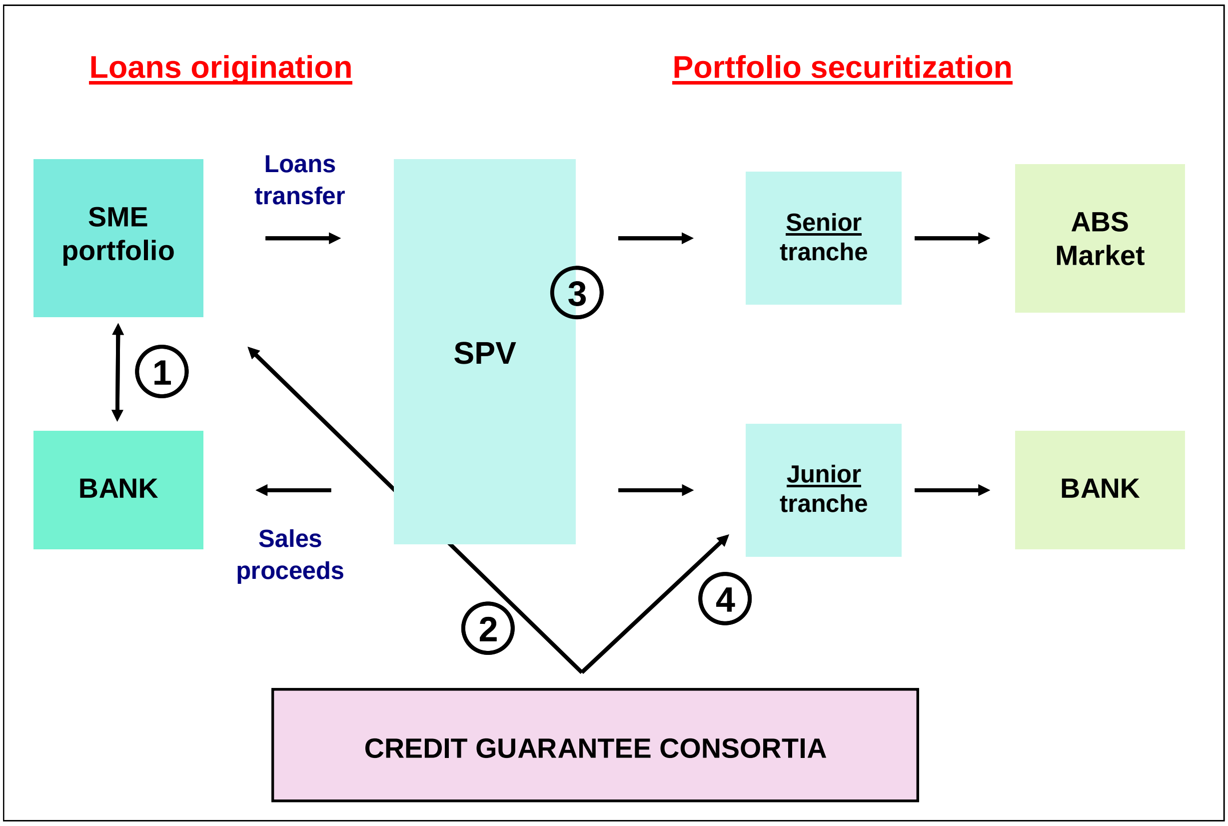

Figure 10: Italian District Bond structure

The benefits of district bonds are:

- Companies are able to access international capital markets;
- Medium- and long-term funding is supplied;
- Lower costs compared to traditional bank loans;
- No need to provide collateral;
- Relationship banking is preserved.

d) EIF's Credit Enhancement Activity

The European Investment Fund (EIF) provides support to SME transactions in form of guarantees and has played a prominent role in European SME securitisation. So far the EIF has covered about 50 SME transactions all over Europe (e.g. Belgium, Portugal, Spain, Italy, the Netherlands, Germany, Spain and Austria). The main role of the EIF in securitisation transactions is to cover part of the risk in the transfer of loans from the originating bank to the capital market.

- Both cash and synthetic transactions are covered.
- Equity / First Loss Pieces are not guaranteed (except when adequate protection is provided, e. g. through interest sub-participation arrangements).
- Portfolio or securities should have an investment grade rating before the EIF guarantee (exceptionally, also BB rated tranches can be considered).
- The EIF typically covers tranches up to € 50 million and for a maximum of 10 years average life.
- EIF does not require an external rating.

EIF support requires that at least 50 % of the debtors in the underlying portfolio must comply with the SME definition. Figure 12 illustrates one way of a possible EIF intervetion.

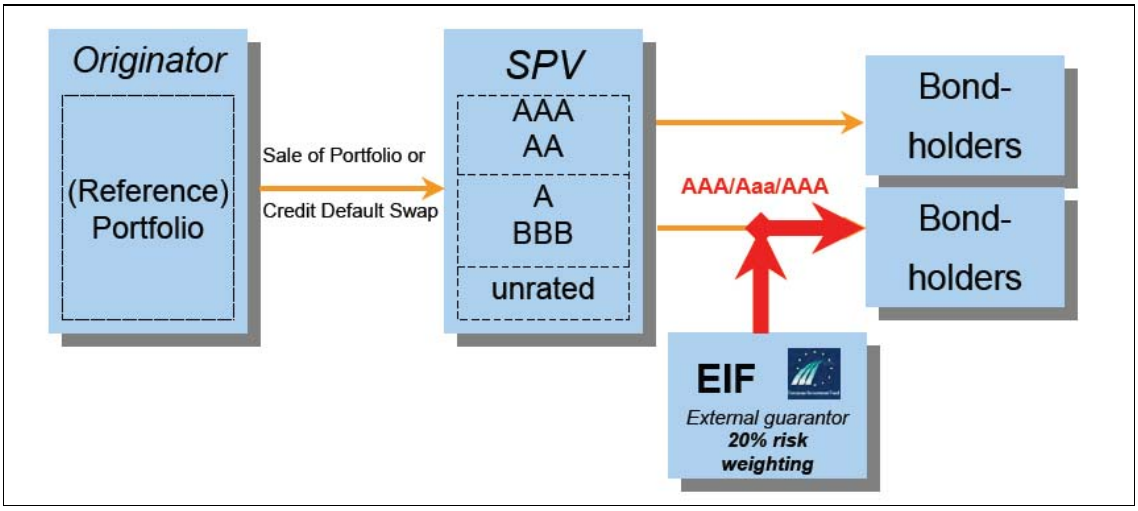

Figure 11: Structure of an ABS transaction based on the EIF Credit Enhancement Programme

In supporting a transaction, the rating of covered tranches is enhanced. For instance a lower rated "BBB"-tranche can be elevated to a higher, usually AAA-tranche. EIF guarantees have the following beneficial effects:

- The guarantee leads to an easier placement of the wrapped tranches with investors. This, from the originator´s point of view, removes uncertainty and supports the marketing of the deal. The EIF thus plays an important role as a catalyst for other investors to take subordinated SME risk.
- Support by EIF increases the liquidity of the secondary market, which is particularly important for the risky mezzanine tranches. [26]
- Smaller banks profit from the EIF´s experience.
- The EIF´s commitment leads to quicker execution and lower transaction costs.

e) Competitiveness and Innovation Framework Programme

The financial instruments of the Competitiveness and Innovation Programme aim to support the development of the market for SME loan securitisation. The fourth window of the SMEG Facility, securitisation, aims to achieve this objective. The securitisation of SME debt finance portfolios shall mobilise additional debt financing for SMEs under appropriate risk-sharing arrangements with the targeted institutions. It will involve sharing the risk of certain securitised tranches which are senior to the first loss piece or leaving the risk of a significant part of the first loss piece to the originator and sharing the risk of the remaining part.

Support for the transactions shall be conditional upon an undertaking by the originating institutions to grant a significant part of the resulting liquidity of the mobilised capital for new SME lending in a reasonable period of time. The securitisation of SME debt financing portfolios will include individual and multi-seller transactions as well as multi-country transactions.

[26] See AMTE report, quoted before

ANNEX 6
GLOSSARY OF TERMS[27]

Asset Backed Securities (ABS) The generic term for debt securities whose cash flow characteristics are determined by specific assets or pools of assets and their assigned priority in the cash flow waterfall (discussed below).

Asset Pools In order to increase cost efficiencies and diversify the credit risk (so that there is no undue concentration on a limited number of obligors), assets securitised are generally grouped into homogenous portfolios with well defined eligibility criteria that enable the risks and the expected cash flows to be clearly identified and quantified.

Credit Enhancement In securitisation transactions, investors take the embedded risks of a portfolio, and make their own assessment as to whether such a portfolio will produce sufficient cash flow to service and repay their investment. In order to bolster the credit quality of a given portfolio, and to achieve targeted ratings on ABS tranches issued, rating agencies often require specific credit enhancements.

Table 14: Principles of Credit Enhancement

Asset Pool	Credit Enhancement	Tranches issued		Credit Enhancement %
€100	Reserve Account: €5	First Loss Piece	€ 5	5
		2nd Lost Piece	€ 5	10
		Senior Tranche	€ 90	15
			€ 100	

Enhancements include over-collateralisation (e.g. €100 of ABS is supported by a portfolio of €110); third party guarantees; and, for all tranches above the First Lost Piece (FLP), the tranche(s) lying junior to it in the securitisation structure. The table above illustrates the principles of credit enhancement: for instance the credit enhancement for the FLP is 5%, being the reserve account; and credit enhancement for the 2nd Loss Piece is 10%, being the sum of the reserve account and the FLP.

Sizing of the credit enhancements for a particular securitisation structure is the key task of the Rating Agencies.

Credit Linked Note (CLN)[28] CLNs are issued by a protection buyer (for instance a bank) to transfer a specific credit risk to investors. A CLN has features of an ordinary bond insofar that investors receive regular payments of interest and repayment of the principal at maturity. What distinguishes a CLN from other bonds is that it links the repayment of the principal and the

[27] Parts of the glossary are taken from: GBRW (2004): Study on Asset-backed-securities: Impact and use of ABS on SME finance; http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/report_en.pdf

[28] http://www.investopedia.com/dictionary/, Richard Bruyere et al. 2006: Credit derivatives and structured credit, a guide to investors, Wiley, Chichester.

payment of interest to the performance of the reference entity. In the case of default of the underlying entity, investors receive an amount equal to the recovery rate.

CLN are either issued by banks or by a special purpose vehicle. In the first case, investors take double credit risk, that of the underlying credit and that of the issuing bank. In case of bankruptcy of the bank, the investors of the CLN find themselves ranked among other investors. In the second case however, investors avoid the twofold risk, and investors only face the risk of the defaulting reference entity.

Economic Capital The amount of capital required to cover unexpected losses. This is an internal statistical measurement made by bank risk managers. Unexpected losses are a "worst case" assessment of loss.

Expected Losses (EL) The expected level of losses arising in one year in a portfolio of assets at a pre-defined statistical confidence interval. It is a function of expected default frequency and assumed loss given default. Expected losses are generally covered by portfolio earnings.

First Loss Piece (FLP) In any securitisation, the most probable credit losses are concentrated in the FLP. This is usually held by the Originator, which in effect often results in only partial risk transference compared to continuing to hold the securitised assets on its own balance sheet. FLPs have high return and risk characteristics, hence are sometimes alternatively referred to as "equity pieces".

Granularity A number of single items in the portfolio pool.

Investor Most ABS instruments are held by wholesale institutions such as banks, insurance companies, pension and mutual funds. ABS offers diversification benefits for Investors, enabling them to choose tailored investment profiles according to return, risk and liquidity requirements. Rating Agency statistics demonstrate that the ABS sector as a whole has superior rating and price stability as compared with corporate bonds. Furthermore, ABS assets enjoy deep and liquid markets ensuring maximum Investor flexibility.

Issuer ABS securities are issued by special purpose vehicles, usually incorporated in tax neutral jurisdictions.

Legal Advisors The legal structure and the legal opinions are crucial to securitisation, so considerable legal work goes into the documentation. Legal fees can be substantial and are often the largest cost for an issue. Consequently, it is generally important for securitisation transactions to reach a critical mass. The bulk of fees are generally charged to the originator, or sponsor.

Mezzanine Tranche The tranche(s) directly above the FLP, which are usually allocated non investment grade ratings. Mezzanine tranches are generally only purchased by ABS market specialists.

Mezzanine Financing[29] Mezzanine finance is a collective term for hybrid forms of finance: it has features of both debt and equity. There are various types of mezzanine finance, each having its own unique characteristics. The most common forms of mezzanine finance include the subordinated loan, participating loan, 'silent' participation, profit participation and convertible bonds; the structuring possibilities are almost endless. (For further details see the Final Report on Mezzanine Finance of the Fifth Round Table between Banks and SMEs.)

[29] http://www.investopedia.com/dictionary/

Originator The party who originally created the claims securitised. Occasionally, this may be a third party who buys the pool with the intention to securitise it thereafter, in which case, they are sometimes referred to as "sponsors".

Rating Agency The assessment of an ABS issue by the credit rating agencies is crucial in the successful execution of a securitisation, since, as a general rule, only investment grade rated debt is purchased by the majority of funds, pension funds and retail Investors. The overall cost of the financing or risk transference provided by the transaction will depend on the relative amounts of the securities issued which are highly rated and can therefore be sold to risk averse investors at small margins. The rating of the tranched securities is done by a small number of well-known and respected rating agencies who have accumulated considerable expertise, data and modelling skills in assessing the expected losses of debt securities. They are paid substantial fees per issue depending on complexity (rather than on size). The independence and reputation of the agencies is a crucial aspect of the role. In assessing the credit of a securitisation issue, the rating agency will look at all relevant factors, the main ones being:

- The quality of the pool assets in terms of repayment ability, maturity diversification, expected defaults and recovery rates;
- The timing of cash flows and any mismatches, plus the impact of defaults;
- Any price risks arising from currency movements and any interest rate risks from the required payments on the issued securities;
- Legal risks in the structure, such as the effectiveness of transfer of title to the assets;
- Insulation from bankruptcy; and
- The ability of the asset manager to manage the portfolio;
- The nature and levels of credit enhancement, which would be stress tested by modelling the impact of severe credit losses and interest rate movements. Rating Agencies also play a key role in assessing periodic performance data on each ABS pool performance. When trends in the pool merit it, tranches of the ABS issue may be upgraded or downgraded.

Standard & Poor's	**Moody's**	**Fitch**		**Standard & Poor's**	**Moody´s**	**Fitch**
Investment grade				**Non investment grade**		
AAA	Aaa	AAA		BB+ BB BB-	Ba1 Ba2 Ba3	BB+ BB BB-
AA+ AA AA-	Aa1 Aa2 Aa3	AA+ AA AA-		B+ B B-	B1 B2 B3	B+ B B-
A+ A A-	A1 A2 A3	A+ A A-		CCC+ CCC CCC-	Caa1 Caa2 Caa3	CCC+ CCC CCC-
BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-		CC C	Ca C	CC C

Reference Portfolio In synthetic transactions, the earmarked portfolio of assets owned by an originator, the performance of which establishes the performance of all ABS securities and credit protection contracts linked to it.

Regulatory Capital The amount of capital required by banking regulators to support a bank's risk assets using specified risk weightings for different asset types.

Risk Weighted Assets For the purposes of calculating the appropriate Regulatory Capital tariff, the nominal value of a loan commitment will carry weighted values of between 0% and 100% dependent (under Basel I) on a relatively simple matrix tracking the nature of the obligor, the amount of security granted, whether the commitment is short term or long term, drawn or un-drawn and other risk features. Basel II will adopt fundamentally the same approach using a more sophisticated matrix including inputs such as rating, default frequency, loss given default and exposure at default.

Servicer The party managing the portfolio of assets on the part of the investors, collecting payments due, restructuring and collecting problem/defaulted assets, and periodically reporting on the portfolio to Investors. The servicer is almost invariably the originator, but there are standby mechanisms in securitisation transactions that enable the servicer to be substituted should its own weakening financial status potentially threaten investors' interests.

Tax and Accounting Advisors Tax and accounting advice and opinions may be needed in securitisation, although fees will form a much smaller proportion of the costs than legal work.

Tranching Tranching is also a central feature of securitisation, and is achieved by the issue of several classes of debt with differing seniority. The most senior are usually highly rated AAA or AA issues that are protected from credit losses by having a priority claim on the cash flow from the assets. The lower rated classes (including the lowest rated tranche, the FLP) are designed to absorb the credit losses first. Cash flows from the assets are used according to a hierarchy of priorities that sees the senior highly rated tranches paid before the junior tranches. The junior tranches receive higher rates of interest to compensate for this. The FLP is usually a small percentage of the total funding, receiving lowest priority in payment.

Unexpected Losses (UL) Unexpected losses measure the losses that could occur on a portfolio in excess of expected losses, usually taken to a very high confidence interval. It thus represents a "worst case" loss. Unexpected losses should be covered by Economic Capital.

Waterfall A key figurative concept in securitisation: the cash flow of the portfolio is first used to fill/refill the requirements of the top tranche; the surplus cash flow then goes to fill/refill the requirements of the second tranche, and so on, until the cash flow is exhausted. The bottom "equity" piece (FLP) receives the residual cash flow after all other prior claims have been satisfied. Dependent on the performance of the asset pool, this residual cash flow will represent a high rate of return when the pool performs well: conversely, if the portfolio performs less well than expected, the bottom piece may in consequence receive zero returns and be irrecoverable.

FIFTH ROUND TABLE BETWEEN BANKS AND SMEs

PARTNERS

Association of European Chambers of Commerce (EUROCHAMBRES)	http://www.eurochambres.be
European Association of Craft, Small and Medium-sized Enterprises (UEAPME)	http://www.ueapme.com
BusinessEurope (UNICE)	http://www.businesseurope.eu
European Association of Cooperative Banks (EACB)	http://www.eurocoopbanks.coop
European Savings Bank Group (ESBG)	http://www.esbg.eu
European Banking Federation (EBF)	http://www.fbe.be
Network of European Financial Institutions for SMEs (NEFI)	http://www.nefi.be
European Mutual Guarantee Association (AECM)	http://www.aecm.be
European Federation of Accountants (FEE)	http://www.fee.be