Yves Mersch: SMEs, Banking Union, and securitisation – exploring the nexus

Keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Economics Conference 2013 "Investment and investment finance: putting Europe on a sustainable growth path", organised by the European Investment Bank (EIB), in cooperation with the Reinventing Bretton Woods Committee (RBWC) and the EURO 50 Group, Luxembourg, 13 November 2013.

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President Hoyer,

SMEs are the pillars of the European economy. 99.7% of the firms in the EU are SMEs. The vast majority of those are micro firms with less than 9 employees. They are also the major drivers of job and wealth creation: the European Commission estimated in 2012 that SMEs employed nearly 70% of EU workers and contributed around 60% of value added. In other words, the health of smaller businesses and the health of the EU economy are thoroughly intertwined.

Europe should therefore be very concerned by the difficulties that SMEs are currently facing – in particular those in countries under stress. Of course, we cannot avoid that certain business models become outmoded and disappear during downturns. This is the nature of the market economy. But the situation facing SMEs in certain jurisdictions goes beyond that. Firms have been forced to close not only because business models were flawed, but because they were located in the wrong place and could not get access to finance.

Two major challenges lie in front of us:

1. Continental Europe remains a bank-based economy, and small businesses mostly depend on banks to finance themselves. It is therefore our responsibility to make sure that banks do not find undue impediments to lend to sound borrowers.
2. At the same time, we should promote other forms of financing to complement the banking channel with non-bank sources of finance through strengthening capital markets and in particular securitisation.

Let me begin my discussion on how to achieve this by briefly reviewing the structure of financial intermediation in the euro area and how it is affecting SMEs today.

Financial intermediation and SMEs

In the euro area, banks have historically played an important role in financing the real economy. Banks loans account for around 50% of firms' external financing, which is very different from the US where around 80% of firms' financing comes from capital markets (equity and debt securities). The importance of bank-based intermediation in the euro area explains the relatively large size of the euro area banking sector compared with the US – at 270% and 72% of GDP, respectively.

However, the crisis has hampered bank lending. Indeed, loans to the private sector have fallen for 16 straight months. On the supply side, heightened funding costs and persistent financial fragmentation in the euro area constrain new credit. This is in part due to the necessary process of consolidation and deleveraging in the euro area banking sector. The sector has decreased in size by about 30 percentage points of GDP since 2008. But it also reflects, on the demand side, the weak economic environment, the need to repair private balance sheets and heightened uncertainty.

The effects of these constraints are not being felt evenly across the euro area.

First, there is considerable heterogeneity in firms' access to bank finance, in particular SMEs. In the last ECB survey on SMEs access to finance obstacles were reported to be very high in Greece, Ireland and Spain (with more than 40% of firms encountering obstacles), more moderate in Belgium, France and Finland (less than 20%), and lowest in Germany and Austria (around 10%).

Second, as regards non-bank financing, access has largely been limited to larger firms and those located in countries with more developed corporate bond markets, such as Germany and France. Our data shows that these firms have been able to partly offset reduced access to bank finance with bond issuance in the last 12 months. But such substitution has not been possible for most SMEs, and for firms located in stressed countries.

There are more than just stigma effects at play here: SMEs are intrinsically highly-dependent on banks for financing. This is because it is often difficult and costly for non-bank financers to get enough information to make informed investment decisions. In addition, SMEs, by virtue of their size and activities, are often more prone to fall into bankruptcy; from a lender's perspective diversifying this credit risk to an acceptable degree requires issuing many SME loans – a role more suited for banks for the time being.

So all in all, SMEs remain very dependent on bank financing, while access to that financing is decreasing. This creates a major barrier to SMEs' investment and growth opportunities – and given their importance to the economy, to euro area growth and job creation. Ensuring access to finance for SMEs must therefore be a central tenet of achieving a sustainable recovery.

Some measures have already been taken to support SME financing. In July this year the Eurosystem recognised the lower risks posed by securities backed by SME loans, taking into account the introduction of the ECB loan level data transparency initiative. In the context of the regular review of its collateral risk control framework, the Eurosystem accordingly reduced haircuts on SME ABSs posted as collateral for its regular monetary policy operations. Elsewhere, a number of public initiatives have also been launched at both the national and European levels to ease the credit constraints of SMEs, for instance through use of public guarantees.

Even though at this stage of the recovery the supply-side is not the major cause of the continued weak lending data but the weak demand, nevertheless, two key priorities ought to be addressed on the supply-side.

The first priority is to support the bank lending channel by strengthening *banks* – that is, by cleaning up their balance sheets and reducing fragmentation in funding markets. I am confident that banking union will help achieve this, not least through its comprehensive assessment of banks' balance sheets.

The second priority is to support the bank lending channel by strengthening *capital markets*. As disintermediation is not an option for most euro area SMEs, a promising middle way is to increase possibilities for the securitisation of SME loans. This could build a bridge between SMEs and non-bank sources of finance.

Let me address each in turn.

Strengthening banks: the role of banking union

The euro area economy is slowly beginning to improve, indeed the latest Commission forecasts project 1.1% growth for next year. In turn, the demand-side constraints on bank lending should gradually lessen. But at this point, supply-side obstacles could become more of a hindrance, because the recovery will lose momentum if banks cannot fund it. A key objective of banking union must therefore be to remove those supply-side obstacles.

There are currently three main obstacles here.

The first is a rising number of non-performing loans on banks' balance sheets and their slow resolution in several countries. This causes banks to preserve capital and avoid risky new exposures, such as those to SMEs.

The second obstacle, which is related, is low investor confidence in banks' asset quality and provisioning. This lack of confidence raises funding costs. This then contributes to higher lending rates for borrowers.

The third obstacle is the absence of a unified framework for restructuring banks, leading to uncertainty and fears of a feedback loop between bank and sovereign weakness.

How can banking union help?

To begin with, the forthcoming ECB assessment of banks' balance sheets has the potential to be a game-changer. By shedding greater light into the euro area banking sector, this review will help remove the uncertainty about asset valuation and funding models. This is currently distorting the price of funding.

Moreover, the review will accelerate any necessary loss recognition and corrective actions. Improving the viability of banks in this way should help ensure there is enough aggregate balance sheet capacity in the euro area to extend new loans to SMEs.

A rigorous and credible exercise is essential to achieve these effects. That is why we have designed it as both a point-in-time risk-based asset quality review and a forward-looking stress test. And this is also why we are putting in place a strong central governance structure that ensures the results are fully comparable. National supervisors and the private firms involved in the assessment operate within the terms of a detailed framework defined by the ECB. Their final output will be subject to a central review to guarantee consistency across banks and countries.

The exercise will capture around 85% of euro area banking assets and hence most real economy exposures. But I also expect it to have an effect on the smaller banks outside the exercise whose major business is lending to SMEs, in particular micro firms.

The assessment will require us to adopt more harmonised definitions of non-performing exposures and forbearance, which will later be applied across the SSM. In several countries this will lead to stricter loss recognition for smaller banks than at present – and so accelerate the process of balance sheet repair even for the banks we do not directly supervise.

Looking further ahead, a second channel through which banking union should help support lending to SMEs is reducing financial fragmentation in the euro area. Both the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) will help here.

First, the SSM should help lessen fragmentation caused by perceived differences in the quality of supervision between euro area countries. We have witnessed the role that this can play in a number of stressed economies in the last few years, where differences in definitions of items such as non-performing exposures led to uncertainty and heightened risk aversion among depositors and investors. The SSM should also lead to less supervisory ring-fencing of liquidity both between banks and within cross-border banking groups. The fact that at present liquidity surpluses in some countries cannot be used to fund needs in others creates fragmentation. This structural disconnect means there is greater divergence in bank funding costs and lending rates than is warranted by the underlying economic fundamentals.

Second, an effective SRM should help reduce financial fragmentation linked to the differing fiscal health of sovereigns. This mechanism will ensure that there is a clear cascade of bail-in-able liabilities for failing banks and that any discretion in the rules is applied evenly across euro area countries. Hence, the funding costs of banks should better reflect their idiosyncratic risk, not the credit risk attached to their sovereigns.

Strengthening capital markets: the role of securitisation

However, it will clearly take some time for these measures to repair the bank lending channel. At the same time, it is unrealistic to expect that SMEs can widely borrow from non-bank investors, at least in the short-term. This is why I see strengthening capital markets through securitisation as an important complement to bank lending. It bridges the financing needs of SMEs with the funds of non-bank investors. It also gives those investors access to relatively inaccessible sectors of the economy with the risk and maturity profile that suits them. Indeed, the rich potential of ABSs for customisation allows a precise matching of liabilities – an increasingly important issue in particular for life insurers and pension funds.

The sums involved are not trivial: at the end of June 2013 insurers, occupational pension funds, money market funds and investment funds together had assets worth almost 16 trillion euros – that is only a trillion euros less than the sum of euro bank deposits. Of course, only a small fraction of these funds could be expected to be allocated towards securitisation. Yet, if more were tapped successfully they could provide an important boost to SME financing.[1]

The problem at present is that the ABS market in Europe is weak: investor-placed issuance remains far below the pre-crisis levels and secondary market activity is thin in many segments. If we are to reap the potential gains of securitisation for SMEs, we need to revive this market. This implies removing some key impediments to its functioning.

A first impediment is misperceptions about ABSs in general. Certainly, ABSs are complex products, involving many entities, legal frameworks and information asymmetries, which can make it difficult for investors to accurately assess the risks involved. We have also seen that they can create moral hazard in lending activity, for example the "originate to distribute" model in the US. And of course, the asset class was one of the triggers of the financial turmoil that began in the US in 2007–08. There, as summarised by Brunnermeier (2009) and others[2], the rise in poorly-understood and improperly-structured securitised products led to a sharp inflow of funding, fuelling a credit bubble amid a reduction in lending standards, and in turn further poor-quality securitisation.

However, we should not over-react: misuse of mortgage-based ABSs in the US for example does not mean that all such products are inherently dangerous. Indeed, in the EU securitised products by and large far outperformed their US counterparts: by one estimate the default rate of ABSs in the EU was just 1.4% from mid-2007 to the first quarter of 2013, compared 17.4% in the US.[3] For senior tranches of European SME ABS, there have been no defaults.

Moreover, the US experience has provided us with important lessons about how to make ABS safer also on this side of the pond. Regulations have been put in place in the EU to ensure that originators retain an economic interest in the performance of the underlying loans and that investors carry out proper due diligence. Significant improvements in transparency have also been achieved thanks to the ECB's loan-level transparency requirements, which cover nearly all euro area cash ABSs.

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[1] See for example S&P "Underwriting The Recovery: European Securitization Could Fund More Lending, If The Regulatory Stance Softens", 22 October 2013.

[2] Brunnermeier, M. (2009), "Deciphering the Liquidity and Credit Crunch 2007–2008", *Journal of Economic Perspectives*, Vol. 23 No. 1, pp. 77–100. See also Bassett, W.F., Chosak, M.B., Driscoll, J.C., and E. Zakrajsek, (2013), "Changes in Bank Lending Standards and the Macroeconomy", *Journal of Monetary Economics* (forthcoming*);* Gorton, G. (2008), "The Panic of 2007", in *Maintaining Stability in a Changing Financial System*, Federal Reserve Bank of Kansas City, and Hall, R.E. (2011), "The Long Slump", *American Economic Review* 101 (2), 431–469.

[3] Source: S&P "Transition Study: Less Than 1.5% Of European Structured Finance Has Defaulted Since Mid-2007", 11 June 2013. Similar evidence can be found in, Moody's Investors Service "Structured Finance Rating Transitions: 1983–2013", 7 June 2013, as well as Fitch Ratings "The Credit Crisis Four Years On…Structured Finance Research Compendium", June 2012, and "EMEA Structured Finance Losses", August 2011.

These changes could go a long way towards reviving investor trust in ABSs. Unfortunately, there is also a second impediment: the potentially uneven and disproportionate treatment of ABS in forthcoming regulations.

Let me specifically point to two measures which arguably may have the most influence on the future of the ABS market: the revisions to the Basel securitisation capital framework for banks and the Solvency II regime for insurers. The Basel III proposals announced at the end of last year would lead to sharp increases in capital requirements for securitisation exposures, particularly for senior high-quality tranches, despite the lack of EU default evidence to support such large changes. All ABS were perceived as too risky due to the US experience in the subprime mortgage markets. But this regulation is like calibrating the price of flood insurance on the experience of New Orleans for a city like Madrid.

Similarly, if adopted the Solvency II framework would prescribe capital charges for insurers of 80% for ABSs with a AA-rating and 42% with a AAA-rating. By contrast, the charges for corporate bonds would be 6% and 5%, respectively. There is little doubt that these regulations would strongly impact the future decisions of banks and insurers to invest in securitised products.

In my view, greater coordination on the political and technical level is necessary to ensure that these regulations treat ABSs in a fair manner and do not lead to overshooting. Regulators need to base their calibrations on data. But unfortunately, there is no single database with high quality and comprehensive data on the global ABS market's historical performance.

Obtaining information on ABS market prices is also challenging. Regulators often have to make do with partial and incomplete data, leading to many conservative assumptions. Therefore, a key "quick-win" here would be to build a common evidence base to ensure that the various initiatives are based on a consistent set of price, performance and liquidity data. Such a database could help ensure that regulations reflect the real risks of ABSs, taking into account the full set of information available on ABS performance across jurisdictions.

A second European "quick-win" could be reaching a regulatory agreement to define principles for high quality ABSs. As I mentioned above, ABSs are relatively complex instruments, and regulators must currently handle a very heterogeneous ABS market, containing – on the one hand – highly granular asset classes such as credit cards, residential mortgages and – on the other hand – large and highly concentrated corporate exposures.

There are also a number of structures out there, with different ways of transferring credit risk, and heterogeneous priorities for payments for investors. A one-size fits all regulatory approach therefore does not work for the ABS market at the moment. That is why I believe the job of regulators could be made easier if a certain degree of standardisation was explored, identifying high quality ABS from other types of ABS. This would also provide greater confidence for market participants. The ECB through its collateral eligibility criteria for monetary policy operations has been defining standards for adequate ABS. These requirements could serve as a starting point for such discussion.

Both these measures would help ensure that regulation that is designed to protect the real economy does not end up suffocating it.

The impact of regulations is further aggravated by their reference to external credit ratings. Structured finance ratings in Europe have been very much negatively affected by the application of "sovereign ceilings". This practice leads to a situation where any sovereign rating downgrade often leads to at least a one-for-one reduction in the ratings of ABS in those markets, which in turn increases capital charges for investors and reduces the information content of ratings.

I find it questionable that, the state of a sovereign, with its own idiosyncratic machinery, continues to dictate conditions for highly-rated ABSs tranches although their structure, composition, and enhancements have carried extremely low default risk. Thus it appears that, in many cases, the "low" ratings of the ABS cannot be based on an empirical justification, but reflect an arbitrary view.

On a separate note, let me finally add that I fully support the initiatives being undertaken by the European Commission and European Investment Bank to stimulate both further securitisation activity and SME lending. These measures should provide a boost to both ABS markets and stressed economies.

Conclusion

Let me conclude.

We see that the bank lending channel for many small businesses continues to be impaired. Yet, the euro area recovery cannot be sustained without well-financed SMEs. In my view therefore, there are few greater priorities than implementing the measures I have discussed above.

First, deepening our capital markets and, second, building a genuine banking union would not only serve SMEs today, but also make our economy more resilient to "the next crisis". Of course, both goals will take time to achieve, but it is imperative that we strive towards them as soon as possible.

My vision for the euro area is that a healthy firm that cannot borrow from a bank in its own country should be able to borrow from one elsewhere – and on similar terms to firms from that country, but therefore also banks need to have access to the necessary information. This is what it means to share a single currency within a single financial market.