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Non-bank debt financing for SMEs: The role of securitisation, private placements and bonds

Discussions at an OECD Financial Roundtable

by
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Reducing bank dependence in financing small-and medium-sized enterprises (SMEs) that are key contributors to economic growth and job creation should help making them more resilient to financial shocks. Various non-bank debt financing alternatives are available and were the focus of a Roundtable discussion that this article draws on. Revitalising securitisation, tarnished during the crisis, is important, by making it safer, simpler and more transparent, and perhaps also by offering some (initial) government and regulatory support. Similarly, covered bonds can be attractive instruments for SME finance. For mid-sized companies, bond issuance and private placements may also provide useful alternatives. All these instruments can and should be tailored to fit the investors' needs. There is no "silver bullet" for SME finance which is exceptionally complex due to the diversity of SMEs themselves. Data transparency, standardisation, regulatory support and raising awareness about available financing options should be among the issues to be addressed.

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I. Background and summary

In the years following the crisis, the credit transmission channel has become impaired as regards quantity, price and distribution of credit. The effects of such malfunctioning are particularly felt by small and medium-sized enterprises (SMEs), especially in Europe. Being heavily reliant on traditional bank lending, SMEs are faced with important financing constraints in a deleveraging environment with restricted credit availability from banks. As credit sources tend to dry up more rapidly for small firms than for large companies during economic downturns, broadening the range of non-bank debt financing instruments for SMEs should help making them more resilient to financial shocks. Given SMEs' importance in all economies, this is also essential for economic recovery from the current economic and financial crisis.

Non-bank market-based financing can improve the flow of credit to SMEs, while enhancing diversity and widening participation in the financial system. SME securitisation, (covered) bonds and private placements are three financing instruments that could be promoted so as to complement bank lending, somehow repair the credit channel and ease SMEs' financing constraints, while better distributing risk amongst market participants.

This was the background of a Financial Roundtable hosted by the OECD Committee on Financial Markets in April 2014 that gathered selected representatives of the financial services sector to discuss issues related to long-term investment and non-bank debt financing for SMEs. The Roundtable was held as part of, and to inform, OECD's work on SME finance, in particular on non-bank financing alternatives. While these issues are of concern for the OECD area as a whole, many of the contributions to the Roundtable discussion had a European focus, given the pertinence of the problems there. The revival of a healthy, safe and high quality securitisation market was promoted by participants as a way to generate alternative capital market funding for SMEs, while providing banks with capital relief that allows for the unlocking of resources and further on-lending to the real economy. Securitisation can act as a credit risk transfer mechanism potentially resulting in a deeper and sounder financial system.

While participants agreed that regulatory reforms are required to improve financial stability and avoid pitfalls of the recent past, parts of current regulation were regarded as unfavourable, potentially inhibiting the revival of a healthy securitisation market by dis-incentivising originators and investors. Several private sector representatives cautioned against unintended consequences of complex and sometimes conceptually contradictory regulation and asked regulators to take that into consideration when designing new rules. Clarity over ongoing regulatory work streams was seen as a necessary requirement for originators and investors who are currently reluctant to participate under an uncertain regulatory framework. Particularly institutional investors who are suffering from a dearth of yield due to the low interest rate environment would like to see regulatory barriers removed that, as they claim, inhibits their participation in a safer securitisation market. A sensible calibration of ongoing regulatory reforms measures (e.g. liquidity ratios of Basel III, Solvency II) was seen to be of paramount importance for the revitalisation of the securitisation market.

Post-crisis public intervention has played a significant role in the securitisation market, particularly in Europe, where the eligibility of asset-backed securities (ABS) as collateral for monetary operations have been driving large part of the market, potentially impeding the revival of a private market-based SME securitisation. Although such intervention was undoubtedly considered as important for banks' funding, it did not foster further on-lending to the economy as it provided no capital relief to the benefiting banks. There was a call for such counterproductive effects and potential unintended consequences of public intervention to be taken into account in relevant policy making.

While capital markets can complement the role of bank lending, the unique challenges of SME financing (especially due to the SMEs' diversity and scant credit information) would not allow for a complete disintermediation of banks when it comes to the origination of SME loans, given the fixed-cost nature of sourcing and monitoring rather small and mostly local firms. The economic viability of SME CLOs (collateralised loan obligations) was highlighted as one of the potential impediments to the revitalisation of that market, since prevailing underlying spreads do not provide for an attractive economic proposition, not least because of the riskiness and relatively weak performance of the underlying loans. At the same time, the recent performance of some types of securitisation in Europe was highlighted as particularly robust throughout the years of the crisis. Understanding the structural strengths and weaknesses of and differentiating between various types of securitisation was felt to be a step forward in revitalising the market. The European Insurance and Occupational Pensions Authority's (EIOPA) proposal on identifying high quality securitisations was welcomed along these lines. In the same vein, support was also expressed for the Prime Collateralised Securities (PCS) initiative.

Transparent and standardised data warehouses were seen as an effective way to resolve the information asymmetry problem, with credit information on smaller firms collected and shared with all market participants (as is already done by the Banque de France for French SMEs). Such transparency allows institutional investors to make their own assessment on the creditworthiness of the underlying loans. Views differed over the desirability of standardisation of products, with some arguing that the capacity to have various degrees of credit enhancement is consistent with the different characteristics of SMEs, while at the same time aggregating large pools of SME loans allows for the smoothing out of idiosyncrasies. Contrary to other capital market products, standardisation of SME-related issuances could be counter to the very nature of SMEs, which are inherently diverse.

The double recourse offered by covered bonds and the consequent preferential treatment from a regulatory standpoint was pointed out as the main difference between securitised SME loans and SME covered bonds. Recourse to the originator bank improves liquidity for the instrument, but the regulatory treatment seems to be the main reason for the popularity of covered bonds. Despite its attractiveness as a financing instrument, covered bonds could not be the sole form of capital market finance for SMEs, not least due to asset encumbrance considerations as well as, in some countries, the lack of adequate regulatory frameworks.

The potential for growth in the European private placement (PP) market for SMEs was unanimously expressed, proposing the standardisation of documentation and processes along the lines of the US PP market, as a way to foster this nascent market. Besides the positive role of Government-sponsored enterprises (GSEs), the credit scoring provided by the US National Association of Insurance Commissioners (NAIC) was highlighted as an important enabling factor of a substantial PP market in the United States, although views differed as to whether such initiatives should be led by the official or the private sector.

Recognising that there is "no silver bullet" for SME financing given the complexity of the SME space, there was a call for a joint effort for the development of a healthy non-bank debt market for SMEs, involving all constituents concerned: investors, issuers, intermediaries, regulators and public policy makers. Such financing, when used properly, can play a significant role in the recovery of the real economy by unlocking resources and capacity for further lending, broadening the SME investor base and diversifying their portfolios, as well as assisting in the creation of a sounder financial system through better risk sharing within the economy.

II. Securitisation

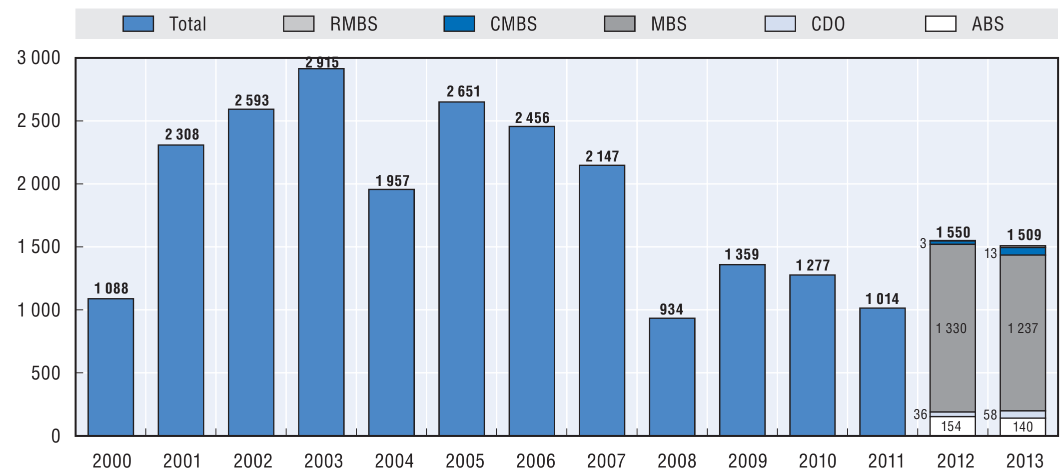
1. *Current standing of the securitisation market*

Securitisation is a tool that, inter alia, can help mitigate credit supply problems by allowing banks to refinance loans, diversify their funding and benefit from capital relief. Being more liquid than their underlying assets, securitised assets can also be particularly attractive to institutional investors, offering diversification opportunities in asset classes that they would or could normally not invest in. Potentially inadequate regulation for some types of securitisation, complex structuring to "improve" risk diversification and misalignments of interest between originator and investor (full offloading of risks, "originate-to-distribute" models) led to underpricing of risk and higher than expected default rates.[1] Such defaults, together with liquidity squeezes, undermined the securitisation model as a whole and led to a sharp post-crisis fall in securitisation overall (see Figures 1 to 3). Another cause was the quasi extinction of special purpose vehicles (SPVs) off banks' balance sheets. A major part of securitisation (up to 75% in the run-up to the crisis according to some estimates) was done for risk transfer, offloading risky assets to SPVs. While such SPVs were the main "buyers" of securitised products they added another risk, a maturity mismatch between assets and liabilities in SPVs to the extent they were money market funded. Failure by market participants to recognise the importance of inherent financial market instability and event risk – as was the possibility of a downturn in the US housing market – was thought by some to be part of the problem and warrant a more cautious approach toward securitising risk.

Such problems have been recognised in policy responses to the crisis and have been addressed in recent regulations that aim to tackle pitfalls of the past and to restore investor confidence. Recently implemented regulations require risk retention or "skin in the game" from the issuers' side, removing misalignments of interest and information asymmetries between originators and investors. Such information asymmetries are also addressed through enhanced due diligence requirements, increased transparency and promotion of greater availability of information on loan-level data, asset performance, documentation and other deal structure-related information.

Figure 1. **Securitisation issuance: United States**

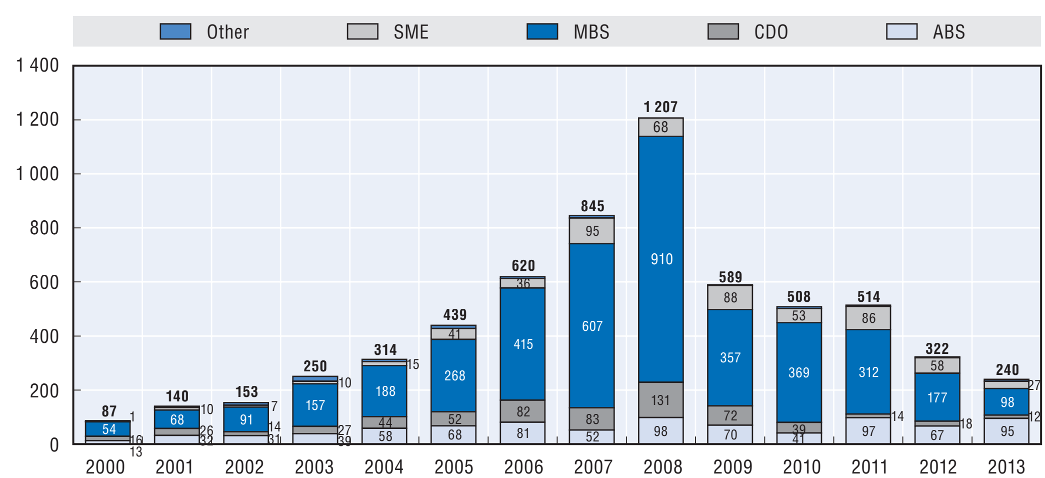
Annual issuance levels, 2000-13, in billions of euro



Source: Bloomberg, Citigroup, Dealogic, Deutsche, JP Morgan, Bank of America-Merrill Lynch, RBS, Thomson Reuters, Unicredit, AFME & SIFMA.

Figure 2. **Securitisation issuance: Europe**

Annual issuance levels, 2000-13, in billions of US dollar



Notes: "ABS" includes Auto, Consumer, Credit Cards, Leases, and other ABS; "MBS" includes CMBS, RMBS, and Mixed; "Other" includes Whole Business Securitisations (WBS) and other securitisations.

Source: AFME/SIFMA Members, Bloomberg, Dealogic, Thomson Reuters, prospectus filings.

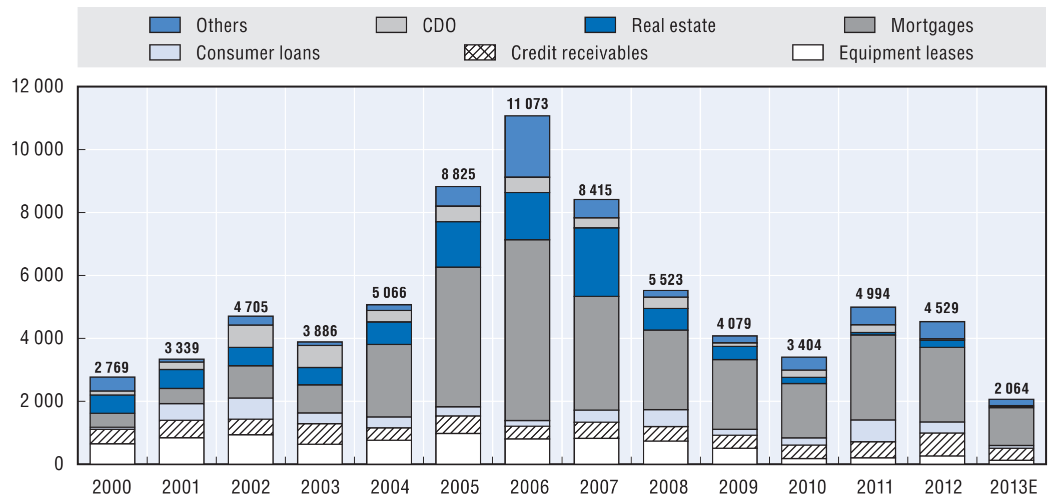
Despite post-crisis efforts to reduce the danger of excesses of the past, the securitisation market is still suffering from the labels attached to it at the height of the 2007-08 subprime crisis and issuance levels have yet to rebound to pre-crisis levels, particularly so in Europe. A number of factors that prevent issuers and investors from reviving the market were raised by participants, varying from regulatory treatment and public intervention, to economic viability, transparency and standardisation.

2. Regulatory impact on the revival of the securitisation market

High level policy makers have raised the issue of the revival of the securitisation market through increasingly regular statements calling for the return of a sustainable securitisation market. In Europe, the European Central Bank (ECB) and the Bank of England,

Figure 3. **Securitisation issuance: Japan**

Annual issuance levels, 2000-13, in billions of Japanese yen



Note: Estimates for the year 2013 cover January-July issuance.
Source: Thomson Reuters, Deutsche Securities Inc.

among others, have been vocal supporters of the revitalisation of a publicly-distributed ABS issuance on a meaningful scale, calling for concerted policy action involving a range of official entities, including EU and international regulators.

Post-crisis regulatory response designed to enhance the system's overall resilience was seen as necessary to impede the resurgence of complex and opaque securitisation structures that contributed to the financial crisis. Nevertheless, the proposed regulatory treatment of securitisation, designed to address the flaws of the past, was perceived as unduly harsh, particularly so in Europe. A number of ongoing regulatory reforms intended to make the financial sector safer may, it was argued, run counter to fostering securitisation by dis-incentivising originators and investors.

The revised proposals of the Basel Committee on Banking Supervision on the revised securitisation framework, EIOPA on Solvency II treatment of securitisation and the forthcoming implementation of the Liquidity Coverage Ratio gathered particular attention. While some good progress was agreed to have been made compared to initial proposals, these regulations were still deemed as unduly onerous on both banks and investors. Despite a decrease in the risk weighting for securitisation exposures under Basel's revised proposal, the corresponding capital requirements are still sharply increased compared to the current framework and were considered harsh for banks. Capital charges for insurers prescribed by EIOPA's proposals under Solvency II are incrementally positive but were still considered as unduly onerous for insurers. EIOPA's proposal for the recognition of high quality securitisation in the context of regulation was welcomed as a positive step forward. In the context of the liquidity regime discussion in Europe, SME securitisation was not expected to be included as eligible High Quality Liquid Asset within the liquidity coverage ratio, although this remains to be clarified.

The constructive engagement of regulators with the private sector through public consultations and ongoing discussions was highly appreciated. Sensible calibration of the abovementioned three critical regulatory workstreams was seen as a pivotal step towards the revitalisation of the securitisation market. Regulatory uncertainty was also perceived as a key constraint, as investors require a clear and solid framework in order to engage in the market. Regulatory failure to remove the impediments to a transfer of corporate loan risk from bank balance sheets, still under continuing deleveraging pressure, to the institutional investor sector, which in a low interest rate environment is suffering from a dearth of yield, was deemed as unfortunate. Regulation designed as a reaction to a crisis was separately suggested to be prone to such difficulties or drawbacks, without undermining the importance or relevance of counter-measures put in place in the aftermath of the crisis.

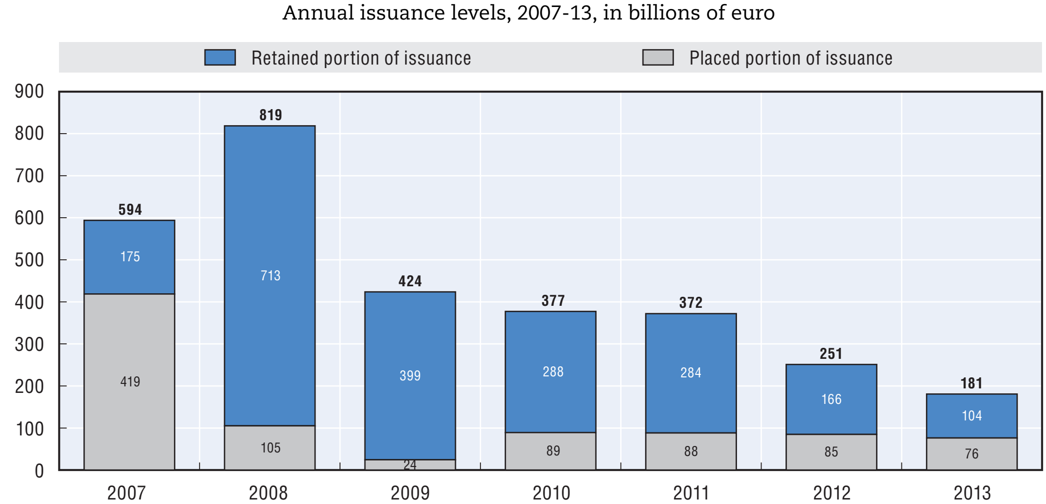
3. Unintended consequences of public policy for SME securitisation

Unintended consequences of prevailing regulatory and monetary policy regimes raised by participants were not limited to the ongoing regulatory debate but extended to post-crisis public intervention. In Europe, the ECB, the Eurosystem and national central banks (NCBs) played a focal role in supporting the bank lending channel to enhance the availability of credit to SMEs. ABS became eligible for the first time under the collateral framework of the Eurosystem. In addition to normal procedure (conventional requirements of general documentation), there has been an exception for ABS whose underlying assets include SME loans to become eligible as collateral for funding purposes through monetary operations in the Eurosystem, even if they do not fulfil the normal conventional assessment requirements.

Although allowing the posting of SME securitisation as collateral with the ECB was viewed as undoubtedly beneficial given the collapse of the interbank market, it was highlighted that such policy had a detrimental effect to the revitalisation of the real securitisation market, with most issuances being retained rather than placed in the market (Figure 4). The key benefits of securitisation were not achieved through these funding operations, as they provide no capital relief and therefore do not allow for further on-lending through redeployment of funds to the real economy and to the SME sector. At the same time, the absence of a capital relief does not assist in the deleveraging effort of the banks. Based on the principle that capital is fungible, it was suggested that more standardised asset classes, which are easier to securitise, are promoted in securitisation for capital relief purposes, creating headroom in banks' balance sheets to be redirected to SME lending.

Figure 4. **European securitisation: retention rates**

Annual issuance levels, 2007-13, in billions of euro

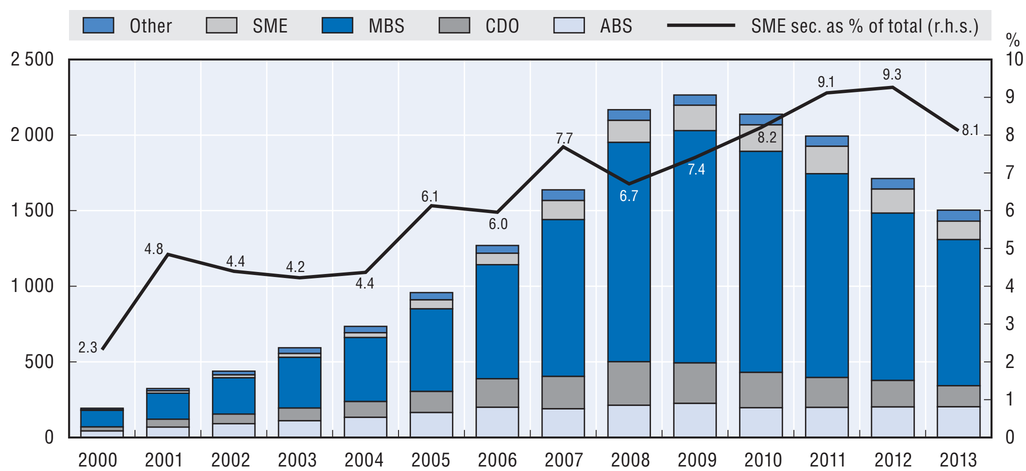


Source: AFME, SIFMA, Bloomberg, Dealogic, Thomson Reuters, prospectus filings, Fitch Ratings, Moody's, S&P.

The share of SME in overall securitisation in Europe is small overall (Figure 2, issuance, and Figure 5, outstanding), with the largest shares of issuance taking place in Spain and Italy (Figure 6). SME securitisation support as currently extended by the European Investment Bank and the European Investment Fund were acknowledged as highly professional and well-intentioned, but public support, in particular eligibility of such instruments for ECB collateral, was seen to potentially carry counterproductive effects, blocking the revitalisation of a market-based SME securitisation. Supported deals end up in a similar way as collateral for repurchase agreements by European banks seeking cheap funding from the ECB. Further development of current schemes should preferably allow market-based perceptions and pricing of risk, once the current regulatory inconsistencies are overcome.

Figure 5. **European securitisation outstanding by collateral**

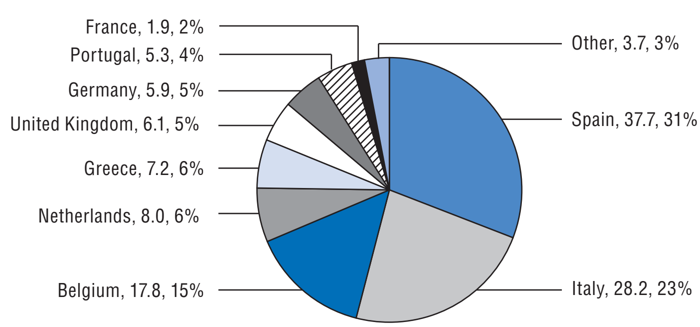
In billions of euro (l.h.s.), and SME securitisation per cent of total securitisation (r.h.s.)



Notes: "ABS" includes Auto, Consumer, Credit Cards, Leases, and other ABS; "MBS" includes CMBS, RMBS, and Mixed; "Other" includes Whole Business Securitisations (WBS), public finance initiatives, and other securitisations.
Source: AFME, SIFMA, Bloomberg, Dealogic, Thomson Reuters, prospectus filings, Fitch Ratings, Moody's, S&P.

Figure 6. **European SME securitisation by country**

Outstanding SME securitisation in selected EU countries, in billions of euro and in per cent of total, as of 2013



Source: AFME, SIFMA, Bloomberg, Dealogic, Thomson Reuters, prospectus filings, Fitch Ratings, Moody's, S&P.

Another similar initiative raised was the acceptance of so-called "additional credit claims" as collateral, which are to a large extent loans to SMEs. Under this framework, euro area NCBs determine the set of eligibility criteria and risk control measures chosen in order to accept these loans (haircuts, probabilities of default) which are in turn approved by ECB's General Council. This framework allows for some kind of differentiation regarding collateral requirements for monetary policy purposes, mobilising unencumbered and performing credit claims, while utilising the "local" expertise at the NCB level. NCBs are supposed to take into account that these additional credit claims reflect local features. NCBs are not only best suited to deal with this particular asset class, but also incentivised given that this is not a loss sharing exercise but one where NCBs bear the risks themselves.

Despite entailing some unintended consequences, such policy initiatives were still regarded as necessary under the particular challenging context, with the caveat that these are not long-term solutions that can resuscitate the SME credit market, but rather temporary measures for the provision of liquidity to the market and potentially to credit-restricted SMEs. From an SME finance perspective, capital constraints, and not funding shortfalls, were highlighted as the real issue, particularly so in an "unusual" environment in terms of monetary conditions, interest rates and liquidity in financial markets that is likely to persist. For as long as banks are still under pressure to de-lever, SME lending will be avoided as SME loans are capital-intensive products for banks to hold on their balance sheets. Regulators were thus asked to review risk transfer rules, understandably tightened after the crisis but maybe too tight, particularly when considering the amount of capital required to be held in the entire system.

4. Economic viability of SME securitisation

As demonstrated by the relevant data (see Figure 4 above), most SME securitisation issued in Europe after the crisis was retained and used as collateral with the ECB, while very little was actually placed, usually just the senior, less risky, part of the structure. The low level of SME securitisation issuances placed in the primary market cannot be solely attributed to prevailing regulatory and monetary policy regimes. The underlying economics of SME collateralised loan obligations (CLOs) or leveraged (corporate) loan CLOs were rather suggested to be insufficient for the placement of such products in the market.

This problem was specifically pointed out by a ratings agency representative who regarded SME securitisation as uneconomic due to the mismatch of the asset spread required by investors against the cost of capital of the issuer. When investors approach SME CLOs they tend to perform a relative pricing, looking for a spread on a SME CLO that is higher than a comparable residential mortgage-backed security (RMBS) reference, so as to compensate for the lack of liquidity in the market for SME CLOs. At the same time, investors perceive the underlying SME loans as more risky and expect an additional premium for the (perceived) additional risk. From the lender's perspective, pre-crisis levels of spreads banks charged on SMEs loans were rather comparable to the ones charged on residential mortgages, although these were said to be slowly increasing recently. As the spreads need to reflect the riskiness of the underlying loans, SME loans were supposed to have a higher spread than residential mortgages based on performance statistics and non-performing levels of SME and residential loans disclosed by banks. As a result, for SME securitisation to be rendered economically viable, asset spreads charged on SME loans by originators would need to increase and/or the desired yield expected by investors to decrease.

Leveraged corporate loan CLOs were mentioned as an interesting comparison to SME CLOs. Leveraged loans CLOs have seen a comeback after the crisis with EUR 7.5 billion of new issuance reported for 2013 in Europe. Although the underlying loans are mostly loans to European mid-cap corporates whose risk profiles are somewhat different to those underlying SME CLOs, the economics of the structure provide a good example of how SME securitisation could become economically viable. In such structures, the entire capital is being placed with investors, from AAA tranches down to the equity tranches, and investors' (asset managers' in this particular case) demand seems to meet the underlying borrowers' along the entire issuance. Such AAA tranches are priced at 140 basis points over Euribor, while the spreads on the underlying loans stand on average at 400 basis points. Based on such an example, it comes as no surprise that originators of SME CLOs opt for cheaper ECB liquidity rather than placement with investors in the primary market.

Views were mixed over the ideal, optimal level of SME asset spreads and its implications for SME securitisation. SME asset spreads were not considered high enough to create a robust cash securitisation market, particularly in the periphery of Europe during the crisis. Thin SME spreads were thought to be justified in countries such as Germany, where default levels were very low and the broad macroeconomic environment allowed for issuance of AAA-rated instruments, but not in countries where SME asset performance did not follow the same pattern. Such thin spreads, deemed unjustified, were also thought to work against the interest of macro prudential stability by driving over-indebtedness. Ancillary revenues generated from products and services related to SME lending were seen as another possible reason behind the issuance of non-economic tranches that cannot be placed in the market (besides monetary operations with central banks), and a potential factor behind low asset spreads in underlying SME loan portfolios. For traditional commercial banks, however, SME loans were considered a major profit centre and a product offering some pricing flexibility when compared to more or less standardised mortgage spreads. SME loans can therefore involve high margins and banks may choose to hold SME loan portfolios on their balance sheet instead of securitising them, further adding to the issue of asset encumbrance.

The high profitability of SME lending was noted as the natural pay-out for the effort small commercial banks put into building longstanding relationships with SMEs, particularly at local level. Yet, despite high profitability, return on capital of SME loans was seen as insufficient and regarded as the key issue banks are currently facing. SME loans are highly capital intensive, with the quantum of capital intensity standing at a multiple of the pre-crisis levels of capital requirements. On top of that, spreads charged were claimed not to reflect these high capital charges.

5. *Financing options, the power of information and limits to disintermediation*

Traditionally, SMEs tend to reach out to their local bank with which they already have a relationship when seeking financing. While such relationship banking has its benefits, it often leads to, or perpetuates, SMEs' lack of awareness of other financing options potentially available to them, as pointed out by a financial consultant. Such options comprise those provided by the "shadow" banking industry, including crowd funding platforms or hedge funds that directly finance small businesses. Moreover, SMEs are generally ill-equipped to deal with investor due diligence requirements. This lack of information and understanding leads to a weaker position of an SME in financing negotiations. This is an area where SME managers or owners need to be supported by independent advice, no matter if it is coming from the regulator or an independent market participant. Such advice and financial education more generally, could empower SMEs to reach out for the best financing option – be it, after all, a bank loan or something more sophisticated – and to enhance competition between finance providers.

Nevertheless, while it is generally accepted that SMEs are overly reliant on traditional bank lending, a complete disintermediation of SME financing was seen as neither achievable nor desirable. This is particularly true for very small and small enterprises, where the cost and ticket size required for capital markets issuance tends to be prohibitive. Pricing, capital intensity, as well as the complex logistics involved in SME loan origination, were seen as factors hindering the disintermediation of banks in SME financing. Initiatives for the "unplugging" of banks, particularly in Europe with the collection of funds from investors that are then directed to SMEs, have been faced with challenges on the origination side: the logistics involved in the origination of SME loans are extremely complex, especially when compared to the refinancing at portfolio level. The local nature of the commercial relationship, the large number of on-the-ground bankers involved and the large dissemination of SMEs, as well as the range of tailored-made products offered to SMEs are all factors adding to the inherent complexity of that type of client. It was therefore argued that rather than replacing or removing some of the actors involved in SME financing, attention should be brought to the proper functioning of the different constituents involved. As such, banks were thought as best placed in terms of underwriting and origination of SME loans, while the possibility of online digital platforms facilitated by public institutions closely related to SMEs was also mentioned as a potential alternative way of pooling SME loans.

The involvement of banks was also thought to be important alongside institutional investors on syndicated loan securitisations through SPVs, particularly in the space of mid-cap company financing. The benefit of having banks alongside investors in such structures is for investors to have the knowledge and equipment to negotiate a restructuring situation. The provision of a framework by the official sector for the transferability of loans was proposed as a potential step forward, particularly as regards syndicated leveraged loans. As in the examples of Germany and France, banking licence laws do not allow for the transferring of a loan from a bank to an SPV since the SPV cannot hold a banking licence in such jurisdictions.

Given the fixed-cost nature of sourcing and monitoring particularly small and mostly local firms, it was broadly agreed that capital market funding and lending by non-banks (direct or via funds[2]) should have a complementary role alongside traditional bank lending channels. For very small firms, issuance in the capital markets would only be made available with very light requirements and constraints (in terms of quotation, listing, supervising and cost). Private placements could ease such requirements but still carry costs that are deemed prohibitive for very small SMEs. This is why for a part of the SME population the portfolio approach provided by securitisation is the cheapest solution, allowing for the sharing of funding and structuring costs and costs of (indirect) access to capital markets. Through its "pooling" capacity, securitisation can be the easiest way to bring capital market money to SMEs, working as a bridge that allows the on-the-ground knowledge of the banks to be deployed with capital markets' funding, insofar as such a bridge does not result in pure "originate-to-distribute" models.

6. Data transparency and data platforms

The main challenge to the pooling and repackaging, portfolio-based approach of securitisation is the provision of enough relevant information for investors to quantify the level or risk involved. Market-based signals, rather than quantitative models, were seen as the best indicator of risk and the right tool for financial market regulators to adequately measure securitised and un-securitised intrinsic investment risk. To that end, participants called for the institutionalisation of an ongoing, public, permanent process of exchange between actors with differing risk perceptions, like between buyers and sellers, and the disclosure of relevant information to both sides of a deal throughout the life of the investment.

Such information is particularly important on transactions involving SMEs, given that the SME sector is highly heterogeneous, harbouring sector-specific risks only a fraction of which can be gauged from financial statements. SME entrepreneurs are often less prone, willing or able to share risk sensitive information, while sourcing and monitoring SME financing entails a significant fixed cost for market participants. As a result, there was a call for public support by public financial institutions in order to compensate for this structural cost disadvantage SMEs have to face as compared to larger borrowers. However, outright subsidisation should be avoided and to that end, the support should rather come in the form of building and operating SME DataWarehouses with full transparency and granularity at loan level data, which would be treated as a public commodity, freely accessible to all qualified users like institutional investors. Without doubting the capacity of the public sector, a private sector initiative was expected to be able to deliver such widely consolidated and standardised repositories in a more expedient manner, by refining the large amount of data already available but currently lacking standardisation, accuracy and minimum quality requirements and allowing for their meaningful use.[3]

The lack of loan level data, a veritable information asymmetry, was felt to have often inhibited the development of more rigorous fundamental analysis. DataWarehouse platforms should aim at this, beyond the collection of mere balance sheet and P&L data, in order to build critical, qualitative know-how across a wide array of industry sectors that would be instrumental for better assessing investment risk. Such platforms would also allow for a possible repositioning or even for necessary restructuring efforts by individual members of the pertaining SME universe, either initiated on their own or nudged by monitoring participants. It was argued that a facility with even remotely comparable capabilities does not yet exist and would take years to build, involving substantial public investment that could only be justified by the paramount relevance of the SME sector for growth, innovation and employment. Suitable platform solutions and their trade-offs (e.g. region-wide vs. national, strictly public vs. in cooperation with the private sector, protection of confidentiality vs. open data) are yet to be explored in greater detail.

In Europe, such an initiative was launched in 2013 through the European DataWarehouse (ED), comprising loan level reporting for underlying loans of ABS issued in Europe. ED is the first ABS warehouse ever created that is owned by its market users, and it is being supported and endorsed by the ECB and members of the Eurosystem. The ECB and NCBs, such as the Bank of England, are fully engaged in obtaining greater structural and collateral transparency and both require loan level data to be made available in order for asset-backed bonds to be eligible as collateral at each bank's liquidity operations.

Individual loan information as provided by the ED initiative was, however, thought by some participants to be useful only to the extent that an investor can create his own stratification on the portfolio, given the large number of individual loans each SME portfolio can include (in the tens of thousands). In such cases, looking at individual loans or borrowers is not common practise, unless these represent a large part of the portfolio, which is rarely the case for SME portfolios. On the contrary, portfolios of mid-cap firm loans are more concentrated (including about 50 to 150 borrowers in each such portfolio).

Such standardised, transparent and open DataWarehouse platforms were seen as having the potential to enhance differing perceptions of risk beyond ratings and beyond the awarding of other group-think-inducing quality grading through the dispersion of risk perception, broadening the inherent limitations of available concepts of risk measurement. To that end, the promotion of standardised reporting would assist institutional investors in their risk analysis and portfolio selection process, as is the case with syndicated loans where private equity houses ensure that information packages are made available to investors.

Disclosure of data also includes all forms of external credit assessments, such as ratings assigned by credit rating agencies or credit bureaus, recognised to play a significant role in structuring the market and in default frequency observed. Better information flow between participants allows for better assessment of the risk premium required by investors and easier access to funding by SMEs. Public initiatives such as the one sponsored by Banque de France, assigning ratings to all corporates having benefited from a central bank loan, were seen as extremely beneficial to the system. The limitation of accessibility only to banks (as regulated entities) was, however, noted as a major constraint in this effort. Mimicking such initiatives and broadening their range was strongly suggested, so that more investors can make their own judgements on risks related to SMEs. With asymmetries of information reduced (if not ruled out), and with fewer regulatory impediments, even high risk tranches are expected to be attractive to qualified investors, at adequate yield levels. The modification of banking monopoly legislation was also raised as possibility to lifting impediments to the greater involvement of institutional investors.

7. Data transparency and product standardisation

Concrete actions to make securitisation transactions more transparent and standardised are already being taken by public authorities and the private sector, for instance in terms of standardisation of reporting templates but also in terms of differentiation of "high quality" securitisation products. The Prime Collateralised Securities initiative (PCS) is an independent initiative set up to reinforce the European ABS market by awarding a certification, the "PCS Label", to simple ABS structures that comply with standards of quality, simplicity, transparency and liquidity. The scheme is designed to enhance investor confidence by differentiating between "dangerous", badly performing, unpredictable securitisation and robust, strongly performing, fully transparent and simple issuances.

Such differentiation is also at the heart of the proposal developed by the European Insurance and Occupational Pensions Authority (EIOPA), introducing the concept of "high quality securitisation" for less risky securitisations that fulfil a set of criteria related to the structure of the issuance, the quality of the underlying assets, the underwriting process and transparency for investors, and which would benefit from lower capital risk charges.

At the same time, in the context of the SME universe, complete standardisation was seen as impossible and counter to the very nature of inherently diverse SMEs. The capacity of securitisation to allow for various degrees of credit enhancements through different sizes of tranches and different geometries of credit enhancing is consistent with the different characteristics of SMEs. At the same time, aggregating large pools of SME loans allows for the smoothing out of idiosyncrasies. The high heterogeneity of SME pools was seen as an important source of attractiveness to private investors, with some arguing that despite a fairly high implied probability of default of individual SME loans, the relative stability of SME portfolios renders them attractive from the standpoint of a private investor.

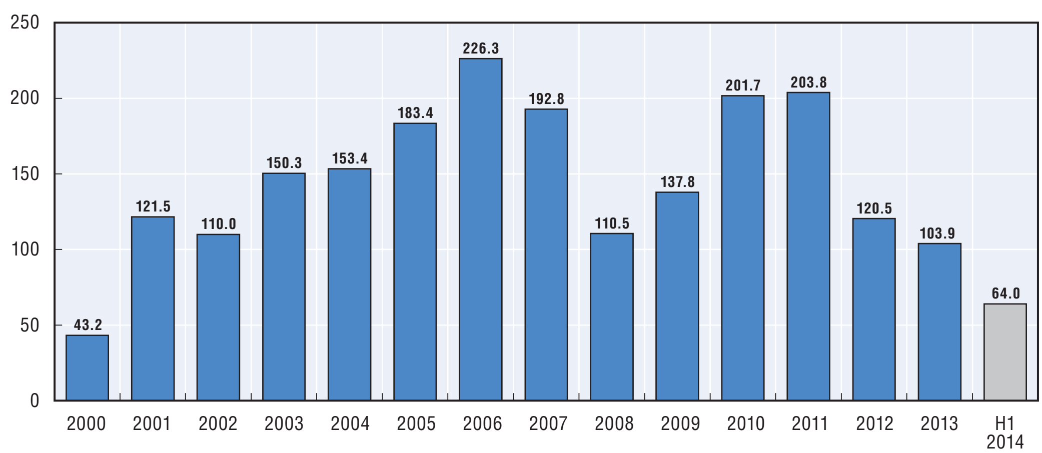
III. Covered bonds

1. *Current state of the covered bond market*

Compared to securitisation, covered bonds have emerged from the crisis relatively unwounded (Figure 7), and remain one of the key components of capital markets, providing cost-effective and diversified funding to issuers and a safer alternative to senior unsecured securities for investors. The attractiveness of the instrument, particularly in Europe, lies to a certain extent in its potential to enable the channelling of funds to the real economy in an efficient and simple way, away from complex originate-to-distribute models, thus ensuring financial stability. In Europe, favourable eligibility treatment in the context of ECB's (and other central banks') operations has further encouraged issuance levels.

Figure 7. **European covered bond issuance**

Annual issuance levels, 2000-13; semi-annual for 2014 (first half-year), in billions of euro



Notes: Includes Cedulas Hipotecarias, Lettres de gage publiques, Obligations Foncieres, pfandbriefes, issues in Italy, Ireland, the UK and Other European covered bond issuance.
Source: Thomson Financial.

The resilience of this asset class during the recent years of market turmoil is mainly attributed to its key "safety" features, namely the strict legal and supervisory framework and the double recourse that investors enjoy, which was pointed out as the main differentiating factor between securitisation and covered bond issuance. The double protection against default (recourse to the issuer and to the cover pool), allows such instruments to be rated higher than the issuer's senior unsecured debt. For the same reason, covered bonds enjoy favourable regulatory treatment (Solvency II, BIS capital charges, Basel III Liquidity Coverage Ratio, bank bail-ins/resolutions), which was generally agreed to be the main attractive characteristic of the instrument. Recourse to the originator generally improves the liquidity of the instrument, attracting wide investor and issuer interest.

Despite their numerous benefits and attractive characteristics, covered bonds were seen as a complement, rather than substitute to securitisation and other capital market instruments. This is mainly due to the fact that they stay on the issuing bank's balance sheet and do not provide the possibility of risk transfer and regulatory relief offered by securitisation. Asset encumbrance concerns further restrict their use in the current deleveraging environment, and limit their role as substitute for securitisation. That said, the low rate environment is pushing institutional investors towards alternative instruments and such quest for yield would be expected to promote the growth of covered bond issuance, especially given the instrument's relatively favourable risk characteristics.

2. SME-backed covered bonds

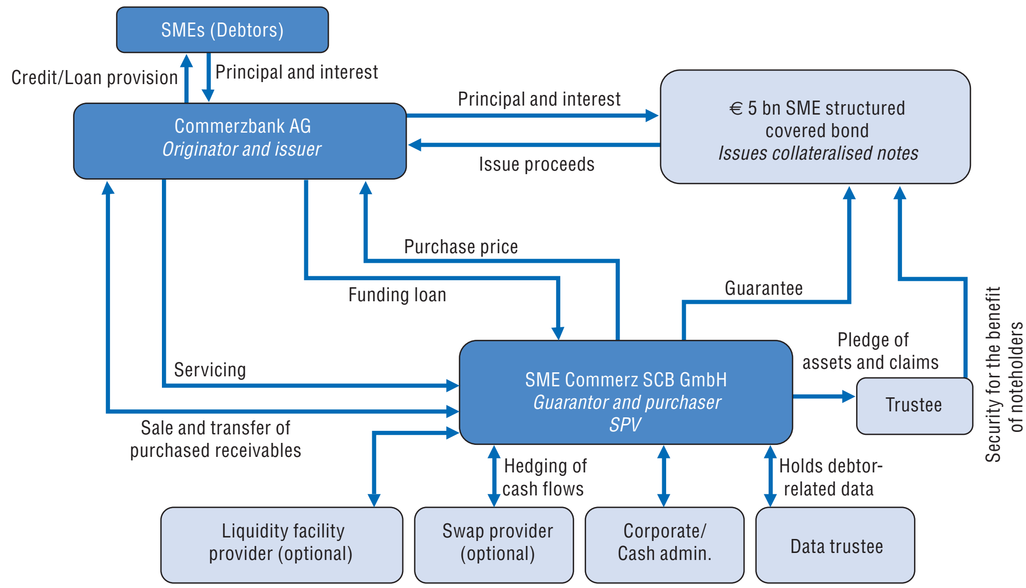
In order to raise financing for SMEs, SME loans can be bundled together in a cover pool against which covered bonds can be issued. However, the absence of a specific regulatory framework in some countries did not allow for issuance of covered bonds in the past, while national frameworks did not necessarily allow for international transactions. This has been changing with the gradual introduction of covered bond legislation (e.g. Australia 2011, United Kingdom 2008, Portugal 2006, and Greece 2007) or the update of existing rules. Nevertheless, to date, the use of SME loans as an asset class in covered bonds is not permitted in the legislation of many countries with an active covered bond market. The majority of covered bond regulation is mostly geared towards mortgages and public sector loans.

Besides statutory shortcomings, the issuance of SME-backed covered bonds is faced with the same inherent difficulties relative to credit risk assessment that are present at the SME securitisation market. Information transparency is a key feature necessary for the promotion of such instruments, and the lack of transparent, standardised information on the credit profile of underlying SME loans is still an impediment to investors in their credit assessment process. It should nevertheless be noted that, when assessing a covered bond, investor focus is somewhat moved away from the cover pool towards the credit of the originator, given the double recourse feature of that instrument. The investor base for covered bonds is different than the one for ABS, as the risk-reward profile of the instruments is very dissimilar, raising the question of sufficient investor appetite for this instrument.

Turkey was one of the first countries to allow the option of SME-backed covered bond issuance through specific legislation, counting many such issuances. In Germany, Commerzbank issued a structured covered bond in 2013, the first one to be backed by loans to German SMEs. Given that SME loans are not eligible under the German Pfandbrief[4] legislation for covered bonds, Commerzbank used a contractual structure with a special purpose vehicle (SPV) and a Trustee for payments under a priority of payments (Figure 8). Investors were offered dual recourse to the issuing bank as well as to a guarantee provided by the SPV.

Commerzbank's SME covered bond was issued with a 5-year scheduled maturity and a switch to pass-through option in case of insufficient funds, carried a fixed coupon of 1.5% and was issued at par.[5] Its pricing was seen as very competitive, particularly given that the implied spread was below the senior unsecured funding spread of the originator. Commerzbank issued an SME CLO from the same part of the balance sheet, used as repo collateral with the ECB. The two issuances were rated by the same rating agency and had a very similar risk profile. Interestingly enough, the originator opted for both transactions in

Figure 8. **Commerzbank SME covered bond structure**



Source: Commerzbank (2013), OECD.

order to benefit from the better regulatory treatment that a covered bond allows for. From an investor perspective, although the risk profile of the underlying portfolio of SME loans was similar, the recourse to the originator improves the liquidity profile of a covered bond providing an additional advantage, in addition to the preferential regulatory treatment of a covered bond. Over-collateralisation, either mandatory under the legal framework or voluntary for the instrument to achieve the highest possible rating, adds a further safety net for investors. Nevertheless, given that these securities are a single name paper, due to exposure rules there is a limited amount of such bonds that a counterparty is allowed to hold.

The Commerzbank transaction was also used as an example of the high levels of transparency required in such structures and the potential for standardisation. This particular SME covered bond comprises 700 companies, most of them essentially mid-caps with an average revenue level for the companies in the pool of around EUR 500 million, well in excess of the high end of the SME spectrum. The analysis of this pool was therefore performed on a statistical basis, relying on the internal bank model. Such an exercise is only applicable on a fairly granular portfolio, highlighting the importance of transparent and relatively standardised information. Initiatives such as the Banque de France's standardised rating system for small creditors was highlighted as valuable for the fostering of such instruments. The level of transparency required goes beyond the cover pool of SME loans, as comprehensive information on the issuer of the covered bond relative, for instance, to asset encumbrance, is equally deemed important.

The absence of a critical mass of sufficiently sizeable portfolios of SME loans in highly fragmented markets (such as in the case of Italy) was also noted as an impediment to the promotion of such structures. However, the possibility of pooling portfolios by different banks can result in multi-originator structures where each of the individual originators needs to be assessed and rated for the structure to receive a credit rating. Such multi-originator platforms, similar to the initiatives of the European Investment Fund, are facilitated by the existence of standardised underwriting processes.

Originators like Commerzbank or HSH Nordbank (who added a KfW guarantee on its cover pool SME loans so as to meet the requirements of the Pfandbrief Act) used securitisation-style elements when structuring SME-backed covered bonds in order to bypass the absence of covered bond legal framework in their respective jurisdictions. Regulators were therefore asked to work on the introduction and fine-tuning of integrated and consistent frameworks of covered bond regulation, particularly in Europe, so as to facilitate the development of this asset class.

IV. Bonds and private placements

1. *Mid-cap bond markets*

Corporate bond issuance is commonly used by large companies for which it is easier to obtain credit ratings and that can issue bonds in large denominations, typically purchased by financial institutions. For SMEs, however, bond finance is not commonly available, even though several possibilities for midcap companies exist. In the past years several markets have been created for retail bonds. In Germany, BondM market launched in 2010, in the UK, ORB launched in 2010, in France IBO launched in 2012, in Italy ExtraMOT PRO launched in 2013 and MARF (New Alternative Fixed Income Market) in Spain launched at the end of 2013. Despite such national initiatives, capital markets remain relatively fragmented for SMEs and mid-caps, with low levels of cross-border investment in securities other than "blue chips". This was seen to be mainly due to obstacles such as different securities laws, bankruptcy laws and tax incentives, but also due to investors' tendency to discriminate between the different types of bonds depending on the perceived quality of the underlying collateral. Another reason may be that so far experiences with SME bonds have been mixed, especially in Germany, with many downgrades and high default rates, and concomitant concerns over transparency, accounting and rating standards.[6]

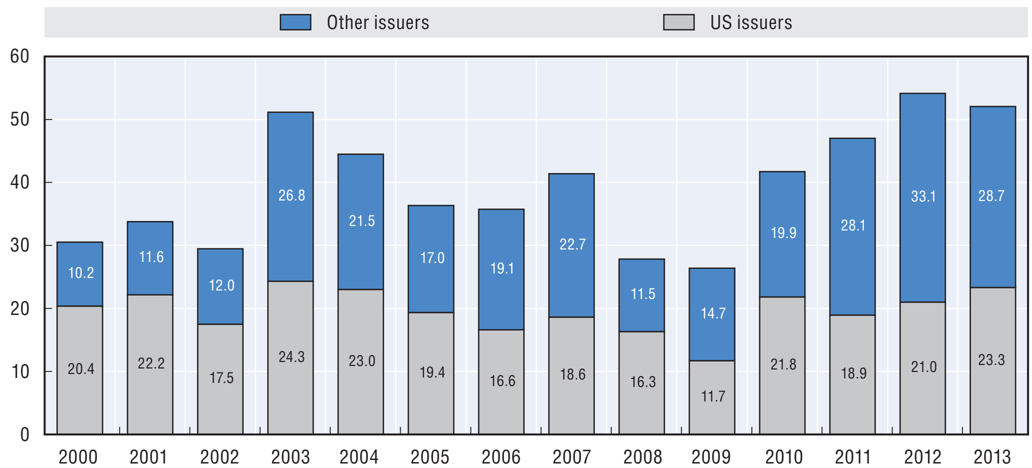
Cost and reporting requirements associated with bond issuance make this market suited mostly to the upper segment of SMEs and beyond, essentially medium-sized and larger companies.[7] There are also intermediary vehicles that pool small cap bonds in funds, offering diversification to investors. The small cap bond fund Micado in France was mentioned as a successful example of such bundling, but such structures, and their success, have been limited. Innovative "mixed" structures combining characteristics of mini-bonds and securitisation have also appeared, such as the Viveracqua Hydrobond project in Italy: a group of eight Italian water utility companies issued ABS backed by their mini-bonds on a cross-collateralised basis.

2. *Current state of the private placements market*

Private Placements (PP) can offer an alternative to public corporate bond issuance, potentially broadening the availability of finance for medium-to-large unlisted companies. The principle attraction of private placements is that they provide a source of funding without the need for a formal credit rating and reporting requirements expected in other capital market debt products. Where regulatory frameworks allow private placements, some markets have already been developed. Besides the US private placement market, which is available to both US and non-US companies (Figure 9), the most well-known PP markets in Europe are the *Schuldschein* market in Germany and the *Euro PP* in France.

Figure 9. **US private placements**

Annual transaction levels, 2000-13; in billions of US dollar



Source: Thomson Reuters, OECD.

Growth of the existing markets, as well as cross-border issuance (mostly tapping the US market) indicate that there is a growing supply and demand for these products. However, lack of standardised documentation and information on the creditworthiness of issuers, lack of liquidity in the secondary market and differences in insolvency laws are all obstacles that hinder stronger growth of these markets on a national and cross-border level. So far, international investor demand is mostly met by US PPs.

3. The case of Private Placements for mid-sized companies

The key benefit of taking the private placement route for small and mid-sized companies is the diversification of their funding away from bank lending through privately placed bonds, without the need to secure formal credit ratings required for publicly traded debt issuance. That said, some assessment of their creditworthiness is indeed required, and to that end, credit ratings agencies have been active in providing special mid-market evaluation procedures that analyse mid-sized companies' credit profile and help investors without the in-house capability to better navigate this complex and relatively opaque market. With no minimum size limit, privately placed bonds can cater to the needs of SMEs for small tickets with issuances in the single digit USD million being delivered to very small companies.

The direct relationship between lenders and borrowers allows for the development of a closer connection with investors, which is beneficial to smaller companies with limited visibility in the public markets and the wider investor community. The role of institutional investors in promoting the private placement market was seen as critical and essential, as they constitute the driving force in the efforts made particularly in Europe. The interest of institutional investors was understood to be based on a search for higher yield, asset risk diversification and long-term assets matching. Nevertheless, the number of active investors is indeed limited and the investor pool dominated by large institutional investors who have developed their own credit assessment capabilities. The lack of liquidity and secondary markets is another obstacle for investors, but does not seem to be an issue for buy-and-hold long-term investors. Syndication or club deals structured by lead investors were proposed as ways for a broader number of investors to participate in such markets.

Interestingly, a disconnect was often noticed to exist between the expectations of issuers in terms of modest cost of funding and the high expected returns of investors participating in PP markets.

Besides an under-developed investor base, lack of standardisation was highlighted as one of the key barriers to the development of the nascent PP market in Europe. Lack of standardised documentation increases the issuing cost (advisory, legal fees and other), as individual agreements need to be drafted for each transaction. Documentation standardisation was seen as one of the enabling factors in the US PP market, which benefits from standard loan documentation (Model Note Purchase Agreement) and covenants, rendering it a user-friendly "off-the-shelf" product which is more straightforward and attractive to both investors and issuers.

Regarding the United States, as pointed out by a CMF delegate, a large part of the success of the US PP market was attributed to the role of the National Association of Insurance Commissioners (NAIC). US PP issuances receive a credit scoring by the NAIC and investors are provided with regulatory guidance on capital weighting. Although the existence of a credit scoring mechanism was recognised as an important enabling factor for the thriving US PP market, views differed as to whether such initiatives should be led by the public or the private sector. In practice, when the NAIC's Securities Valuations Office (SVO) provides credit quality assessment for a PP issuance, the first insurance company actually buying the PP pays for this service and all subsequent purchases by other insurance companies benefit from the already attributed credit scoring. The cost of such analysis is modest (under USD 5 000), the SVO ratings are recognised by the regulator and the system is designed to align incentives with regard to information. However, according to some, the private sector should be the one leading this effort so as to ensure high quality of service provided and harmonisation of accounting and regulatory discrepancies across markets, as is the case with bankruptcy laws. For Europe, the establishment of a similar mechanism on a European-wide level was proposed as a way to create the level of uniformity necessary for investors to engage in the European PP market.

European issuers have been actively tapping the US PP market over the years, with a third of the US PP market reported to consist of European companies' placements. Investor demand, especially by institutional investors, helps to push for more harmonisation and standardisation of the European PP markets and support their growth, as evidenced by initiatives to create a pan-European private placement market. A European PP market along the lines of the successful US PP model, but without necessarily copying it, was seen to hold great potential for medium-sized companies. At industry level, an initiative led by the International Capital Markets Association (ICMA) is underway, focusing on the investor side and looking at the essential principles and market practices that will attract investors into a PP market with European-wide appeal. Standardisation of documentation to the extent possible, credit scoring, regulatory recognition for capital weighting purposes as well as information sharing and financial reporting by issuers to institutional investors were seen as some of the cornerstones of this effort towards the recognition of PPs as an asset class in Europe. Banks were seen to have an active role in this debate as intermediaries, despite the fact they are somehow less involved with regard to PPs as compared with other capital market instruments, given that PPs do not require underwriting per se or market making. A risk of such a model was seen to be the introduction of an unnecessary dichotomy between perceived investment grade and other credit profiles. The aim of a pan-European PP market would be to cater for a greater diversity of credit profiles, corresponding to the reality of SMEs. The role of public policy was deemed important for the recognition of PPs in Europe as an asset class and their appropriate regulatory treatment.

V. Concluding remarks

Half a decade into the financial and economic crisis, growth remains sluggish and banking sector problems are still inhibiting a more strongly footed recovery in OECD economies from taking hold. As banks are deleveraging, capital markets will have to play a bigger role especially in financing long-term investment, including in infrastructure, SMEs and knowledge-based capital, which are key contributors to economic growth and job creation.[8] SME finance, like SMEs themselves, is exceptionally diverse and complex and faces unique challenges. As such, it was unanimously agreed that no "silver bullet" exists for SME finance and it is only by pushing different ideas, avenues and instruments that we can embrace the different constraints and predicaments. Governments and regulators were called to develop the necessary infrastructure for new financing instruments for SME financing (such as standardised publicly available information, transparent financial reporting, platforms, credit scoring mechanisms, standardised documentation) as well as alleviate some of the regulatory burden associated with instruments such as securitisation. The importance of educating and empowering SMEs and in particular raising awareness on the financing options available, beyond the advice usually offered by SME's "relationship" banks, should not be overlooked.

Notes

1. Such defaults affected mainly US securitisations of mortgage loans of certain vintages in the subprime segment.
2. Such funds could also include joint bank and non-bank funds like ABN AMRO's loan fund set up in cooperation with nine insurance companies.
3. However, some observers would contend that while many banks have the relevant information, they are not willing to share it, thus so far projects with the objective to combine information from different commercial banks have failed; public support alone would not be sufficient; information sharing would have to be mandatory.
4. The Pfandbrief market is the second largest market for fixed income bonds in Germany and has a good reputation with investors due to the particularly high level of security it offers and due to its untarnished credit history. The issuance of Pfandbriefe is bound by the regulations of the German Pfandbrief Act with its high level of requirements with regards to protection for investors.
5. By way of a comparison, Commerzbank also issued a public sector covered bond with a similar term and a coupon of 1%. As of September 2013, the SME covered bond was trading above par, while the public sector covered bond was trading at around 99% of par. While the SME covered bond is structured outside the German Pfandbrief legislation, the ECB treated it as a covered bond for central bank repo purposes, it thus benefits from a favourable repo haircut compared to traditional SME CLOs (Fitch, 2013).
6. In Germany, for example, there are rating agencies specialised on SMEs, like Creditreform, Scope, Euler Hermes, and Feri Euro Ratings Services. According to information provided by the EIF, in June 2014 the 17th SME bond issuer filed for insolvency, the third in 2014. The series of defaults, in particular among renewable energy companies, raised concerns over transparency, accounting and rating standards. Moreover, there are several lawsuits regarding information contained in brochures.
7. In France, this would apply to a "mid-size" segment beyond the SME definition of the European Union (fewer than 250 employees and turnover of less than EUR 50 million or total assets of less than EUR 43 million). This specific segment is designated, by official decree, as, "*Entreprise de taille intermédiaire*" (ETI) and defined to comprise companies with 250 to 4 999 employees, or, if fewer

than 250 employees, with a turnover of at least EUR 50 million and total assets of EUR 43 million. It covers the segment beyond SMEs and the lower one of larger companies.

8. This is also being recognised in OECD's work on institutional investors and long-term investment (*www.oecd.org/finance/lti*), a project that also feeds into efforts at G20 level in this area. Besides infrastructure, SME financing is an important component of this work.

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