Securitisation of SME loans as a means of finance

SME finance, the demise of the SME loan securitisation market and legislative initiatives.

"In what way does the securitisation of SME loans contribute to SME finance and how is this process affected/hampered by legislative initiatives?"

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Abstract

In chapter one SMEs are defined and explained. The chapter further elaborates on their dependency of (diversification of sources of)finance. The difference between internal and external sources is explained, and an overview is given of possible sources, their place in the venture capital cycle and possible implications. Treated are the three F's, bank loans, leasing, factoring, trade credit, crowd funding, mezzanine finance, business angels and venture capital. Also explained is how market failures lead to financing gaps for SMEs and how this is magnified because of the economic environment.

Chapter two elaborates on what securitisation is, how it works and different aspects that come with securitisation transactions. Furthermore, the distinction is made between "conventional" securitisation and synthetic securitisation.

The third chapter explains the link between the first two chapters and how securitisation may help close the financing gaps SMEs face as well as the benefits for banks/originators to securitise SME loans. Important is that through securitisation, banks or originators, are able to transfer the credit risk they have on assets, such as SME loans, and at the same time release capital for providing new loans.[1] An overview is provided of the SME securitisation segment in the market from the year 2000, as well as an explanation is given why the segment is lagging behind and why there is room (at least in theory) for expansion. The main reason found for this are market imperfections and failures. Furthermore, reasons have been given why SME loan securities are theoretically attractive to investors, and who these investors are. Theoretical incentives for originators to engage in, and for investors to invest in (these) securitisation are given. However, fact remains that investor demand is low[2] and, in addition, originators are reluctant to issue to investors.

The last chapter provides a brief non-exhaustive insight on implemented regulations, and those who will be in the near future, which will have effects on the securitisation market as a whole, and also on the SME loan segment. There is a special attention for Basel III, Solvency II, UCITS IV and the AIFMD, of which some rules (and possible effects) are highlighted. The main conclusion is that (most of) these regulations are, even though they are transparency-increasing and systemic risk-reducing, increasing costs for most parties involved, incentivising them for engaging in securitisation transaction to lesser extent.

[1] European Commission 2006-2007, p. 4.
[2] Basel Committee on Banking Supervision 2011, p.7.

Table of Contents

Introduction

It is public knowledge that the European economy is suffering under the financial crisis. Unfortunately, as a result, the SME (Small- and Medium sized enterprise) sector –of which the destiny is infrangibly intertwined with the overall economy - finds itself in dire straits. Many SMEs can no longer fulfil their financial obligations and face bankruptcy. These problems reflect throughout the entire SME sector.
In attempting to express the importance of Small and Medium-sized Enterprises in numbers, mentioning the fact that more than 99% of all European businesses are SMEs, may suffice. In 2012, 99,8% of all (non-financial) businesses were SMEs, which comes down to a total amount of businesses of 20.7 million.[3]
Since the SME sector is of such importance to the overall economy (and constitutes large part of it), it stands high at the European Commissions' priority list.
Before the crisis, it seemed that the sky was the limit. Now, dark clouds of pessimism have formed. How can this be reversed? In what way can we provide many SMEs in trouble with a fighting chance? The European Commission (along with other institutions), has asked itself these same questions, amongst many more.

To me, the questions asked above, are impossible to answer in a complete and satisfactory way. Therefore, in this thesis I am going to elaborate on a (small) fraction of the finance problems of SMEs. With this thesis I hope to (modestly) contribute to possible ways of mitigating or even resolving some of the finance problems of SMEs.

There are many different sources of finance for SMEs which all have their own complications. It is important for SMEs to find a good balance between these sources of finance.
In this thesis I am going to highlight one of the financial tools which can (possible) contribute a great deal for SMEs in attracting loans. [4]
It is a powerful tool with the potential to significantly contribute to the finance world. It provides opportunities, allowing parties to achieve more with a limited capital base: securitisation, and in particular securitisation of SME loans. [5]

Even though securitisation has had a very bad reputation ever since the subprime mortgage crisis, I believe it can still contribute to SME finance, and that it is definitely not as negative as the public generally thinks. This bad reputation originated from the fact that many people blame securitisation for being the cause of the financial crisis. Of course, there are many others who do not think securitisation is the only cause and that it can in fact be part of the solution for it instead.

So what does this subprime mortgage crisis has to do with the bad reputation of securitisation?
In 2006, there has been a significant rise in the amount of home foreclosures in the United States of

[3] Ecorys 2012, p.15.
[4] OECD working party on SMEs and Entrepreneurship 2009, p. 24.
[5] European Commission 2006-2007, p. 16.

America, which in 2007 continued and even got worse. This is believed to be at the base of a financial crisis on national level. This crisis infected the global economy and within a year it led to a global crisis.
What followed were even more house foreclosures, a collapse of the housing market and consumers significantly decreased their spending.[6]
According to general belief, the blame lies with securitisation because securitisation allowed the transfer of bad loans to investors who did not suspect this.[7]
In short , the general conception is that banks gave out mortgage loans of which many were doomed to default. Banks did not have enough incentives to correctly assess the risk of these loans. Because these mortgage loans would be securitised anyway, and the risk would not be theirs, they did not put effort in assessing whether the loan could be repaid or not. This went on (as the loans probably got worse), until the collapse. Many borrowers started to default and the underlying assets of the securitisation lost their value.
Of course the real story is too complex to describe here. This brief explanation is just to illustrate where securitisation in general derives its current reputation from.

Now, does this reputation, or even the possible fact that securitisation contributed to the crisis, mean it should not be used anymore? No, I do not believe so, as there are still many advantages to securitisation. I believe that, governed and guided by the right incentives, the securitisation of SME loans (and other assets)can be used in a positive way for the benefit of the SME sector and be an important key in its' recovery. Regulatory initiatives which contain certain incentives will be treated in this thesis, however as you may see, it is questionable if the right balance has been found between the desired incentives.
In order to get a better insight in what the role of securitisation of SME loans is at the moment , and what it could potentially mean in the future, I will try to answer the research question:

"In what way does the securitisation of SME loans contribute to SME finance and how is this process affected/hampered by legislative initiatives?"

In order to come to an answer, there are four essentials that have to be treated. One of the first things needed, is to know what the financing options for SMEs are, and what the problems are with these options. Secondly, the role of loans in this, and securitisation has to be investigated. For this to be realised, it is essential to know what securitisation is. Thirdly, the link between securitisation and SME finance is necessary, otherwise there would be no cohesion but merely separate chapters. After this, the first part of the research question could be answered as the contribution of securitisation to SME finance is the product of the first three chapters. The second part of the research question can be answered when the last essential is treated: which rules affect the parties in securitisation (and lending) and what are the negative effects that can be distilled from these regulations.

[6] Bianco 2008, p. 2.
[7] Song Shin 2009, p. 309.

1. The financing chain of SMEs and the Venture capital cycle

1.1. SME from a global point of view

A global definition of SMEs is hard to find as different countries use different standards in order to define SMEs. Nevertheless, most countries are using the same parameters in their definition such as: Capital investment on plants and machinery, number of workers employed, and volume of production or turnover of business. Despite these differences it is a fact that no matter in which country, the SME is a class of enterprise which is clearly distinguishable[8] as they constitute an important factor in economies and are an important element for economic growth.[9] For convenience reasons I will use the definition of the European Commission for SMEs in this thesis, since the main focus of this thesis will lay in Europe and specifically the Netherlands. The definition is taken from guidelines directed to SMEs to see whether they can apply for SME support schemes.

1.2. European definition of SMEs

The abbreviation SME stands for Small and Medium-sized Enterprises as defined in EU recommendation 2003/361.[10]
So when is an entity an enterprise? According to the definition this is when it is "an entity engaged in an economic activity, irrespective of its legal form" (art. 1 of the recommendation). This reflects the terminology used by the European Court of Justice in its decisions.
The next question that arises is when you can be defined as a Small or Medium enterprise as in the recommendation 2003/361.
In order to make this definition there are three factors to be taken into account; the staff headcount, the annual turnover, and the annual balance sheet total.[11]
If these thresholds are exceeded in a reference year the categorization will not be affected. The SME status will be retained. If the thresholds are exceeded over two consecutive accounting periods the SME status will be lost. It also works the other way around; previously big enterprises which fall below the ceilings for two consecutive accounting periods will gain SME status.[12]

The first factor is measured in Annual Work Unit (AWU), and for enterprises to be defined as medium-sized it has to have fewer than 250 AWU. In order to be defined as small sized an enterprise should have less than 50 AWU. When the AWU is lower than 10 it is seen

[8] Rathakrishnan 2009, p. 157.
[9] OECD working party on SMEs and Entrepreneurship 2009, p.6.
[10] European Commission 2005, p. 5.
[11] European Commission 2005., p. 12.
[12] European Commission 2005, p. 16.

a Micro-sized enterprise count.[13]
So when an enterprise has between 50 and 250 AWU it is medium-sized, and when it has between 10 and 50 AWU it is small-sized.
The staff headcount is important for determining the category of the SME. According to article 5 of the recommendation 2003/361; included in the staff headcount is full-time, part-time and seasonal staff and includes the following: Employees, persons working for the enterprise being subordinated to it and considered to be employees under national law, owner-managers, and partners engaged in a regular activity in the enterprise and benefiting from financial advantages from the enterprise. Apprentices or students engaged in vocational training with apprenticeship or vocational training contracts are not included as staff according to article 5. Important for the calculation is that anyone "who worked full-time within the enterprise in question or on its behalf during the entire reference year", is seen as being one unit. Part-time work, seasonal work or work for part of the year are counted as fractions of AWU according to article 5.

This is however, as mentioned earlier, not the only factor that has to be taken into account. There are two more factors, but enterprises do not have to meet both. They can choose one of these to which they want to live up. In order to count as medium-sized the annual turnover must stay below 50 million Euros, or the total annual balance sheet must remain under 43 million Euros. To be counted as small-sized these figures must be under 10 million Euro of annual turnover or 10 million Euros on the annual balance sheet. If these figures are below 2 million Euros the enterprise can be counted as micro-sized.[14] Of course this all depends on the AWU factor as well.
In article 4 of the recommendation is explained how these factors are determined; annual turnover is determined based on the income generated by services and sales during a year, after paid out rebates. Excluded from this should be value added tax and other forms of indirect tax. The value of the main assets of a company is represented by the total annual balance sheet. [15]

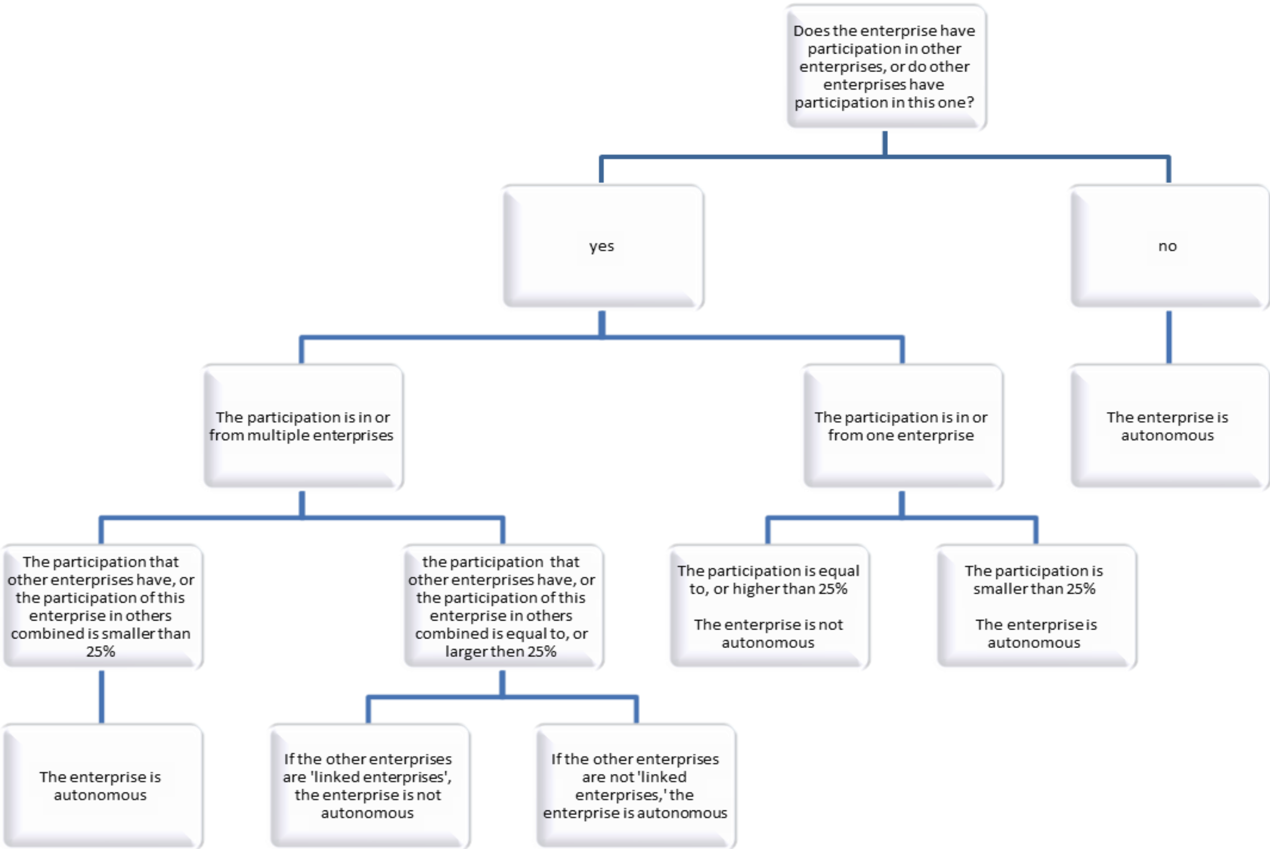
1.3. Autonomous enterprise

When calculating the data one must know whether an enterprise is autonomous. Important in this aspect are relationships with other enterprises. Depending on the category of the enterprise, data might have to be added from enterprises it owns. Of course this can affect whether or not the enterprise meets the categorization ceilings or not. Normally you are considered linked if a consolidated account has to be drawn up by the enterprise, or if the enterprise itself is included on such an account.[16]

[13] European Commission 2005, p. 14.
[14] European Commission 2005, p. 14.
[15] European Commission 2005, p. 15.
[16] European Commission 2005, p. 16.

Article 3 of the recommendation gives more information about this. This diagram might give a better insight of when an enterprise is qualified as autonomous. Being autonomous means you are not linked to, or partnered with, another enterprise.[17]

Exhibition 1: When is an SME qualified as autonomous?



There are some exceptions as to the 25% threshold in art. 3.2; an enterprise can still remain autonomous under circumstances (shown in art. 3.2) if another party has a 25% or more stake in it, if these stakeholders are: universities and non-profit research centers, public investment corporations, business angels and venture capital companies, institutional investors (including regional development funds) or autonomous local authorities with an annual budget of less than 10 million euro and fewer than 5.000 inhabitants.[18]
The enterprise remains autonomous if it has one or more of these investors, as long as none of these has a stake of 50% or higher in the enterprise, again provided that the enterprises are not linked. In this case the stakeholder has its rights as a shareholder but can in no situation influence the management of the enterprise.[19]

[17] European Commission 2005, p. 16.
[18] European Commission 2005, p. 18
[19] European Commission 2005, p. 18.

Enterprises are 'linked' when one has the ability to dominantly influence the other enterprise, or when the "relationship corresponds to the economic situation of enterprises which form a group through the direct or indirect control of the majority of voting rights of an enterprise by another". This was quoted from 'The new SME definition, user guide and model declaration', based on article 3.3., both to which I would also like to refer for a more comprehensive explanation of 'linked enterprises'.[20]
There are more rules concerning partner enterprises and linked enterprises which I will not treat here. Important to know is that the issue of partner and linked enterprises has to be taken into account for possible consolidation, which can influence the categorization of the enterprise.

1.4. The quest for finance

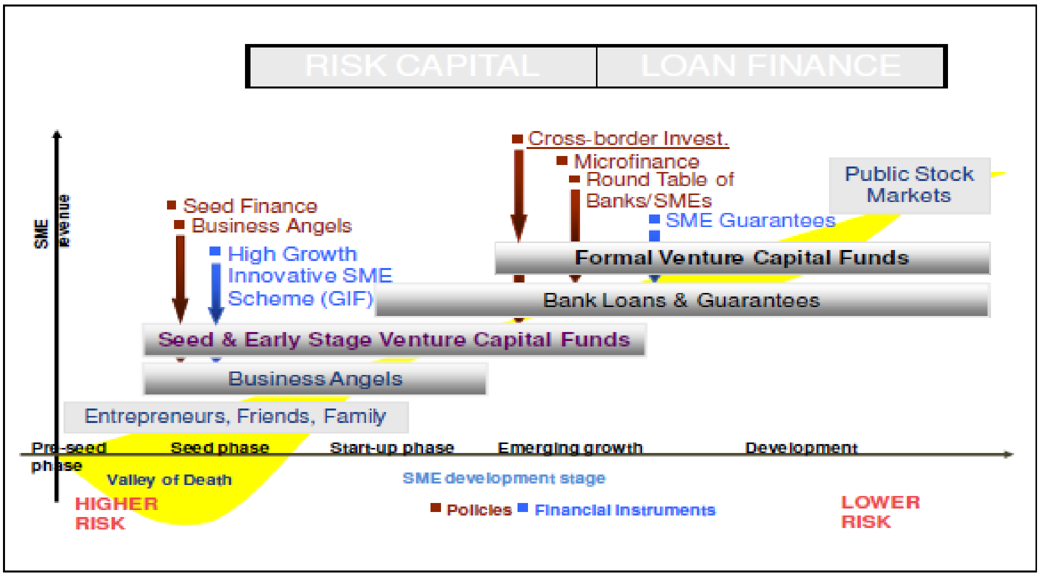
Of course there already have been numerous ways to finance SMEs. In a survey done by the European commission, numerous European SMEs were asked what their most pressing problems were. An amount of 15% of the questioned firms indicated that access to finance was a pressing problem.[21] It needs to be said however that just a part of the SMEs actually desires to obtain finance.
The ways of financing a SME can be roughly divided in two groups; internal and external sources of finance. Internal financing can be achieved through selling assets, investments of the owner, and by allocating retained profits. However, for many SMEs internal sources of finance are not sufficient and therefore they will also require external finance sources.[22] Mainly the fast-growth firms need these external sources which is why I will give more attention to the external finance sources.
The external sources of finance can be divided in informal sources and formal sources.

The three F's as they are called: 'friends, families and fools', is a good example of raising money through informal financing, and will only happen in the early stages of SMEs.[23] The name says it; the capital is delivered by friends or family, or fools ("foolish" enough to invest in the SMEs), and is mainly used in the pre-seed and the seed phase, which is even before the starting up of the business.
Simultaneously (seed and start-up phase) Business Angel investments can be raised (partly at the same time as the 3 F's finance) which constitutes a more formal source of external finance.[24] The same goes for the money raising from the early stage venture capital funds, however these funds will stick around for a longer period than the angel investors.
Additionally there are the more traditional sources of external finance such as overdrafts,

[20] European Commission 2005, p. 23.
[21] Ipsos MORI 2011, p. 14.
[22] Ruis et al. 2009, p.14.
[23] Ruis et al. 2009, p.14.
[24] Ruis et al. 2009, p.14.

loans from banks or other financial institutions (debt finance) and micro credit; loans ≤ €25.000.[25] Banks can give these loans from the time of the start-up of the SME, if they are convinced their money does not go to waste. This however, sounds easier than it is in reality. Furthermore there is leasing and hire purchases.[26]
Other possibilities of external financing can be factoring, trade-credit (commonly used in Europe), or by the use of risk capital in the form of equity financing, mezzanine instruments and venture capital.[27]
These sources are often used in a combination, dependable on three things; the sector in which the SME is active, the growth stage it is in, and its development. Important when raising money by these means of finance is to find a balance between debt and equity in order to make the needs of the business match the finance structure.[28]

Exhibition 2: An overview of the SMEs' finance needs according to the stage of development. Or it could be called: The lifecycle of the company.



Source: Ruis et al. 2009, p.21

1.4.1. Loans by banks

This is usually one of the least expensive sources of finance, and especially convenient for new businesses which are low risk and have a cash flow stable enough for repaying the debt.[29]

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[25] Ruis et al. 2009, p.14.
[26] Ruis et al. 2009, p.14.
[27] Ruis et al. 2009, p.14.
[28] Ruis et al. 2009, p.14.
[29] Bank for International Settlements 2012, p.5.

Of all the external sources of SME finance this is the most frequently used. With these loan SMEs inter alia finance their working capital and investments.[30] The European commission (which sees the importance of SMEs in the economy and thus has done a lot of research) suggests that it is possible that commercial banks may not be able to provide finance to a SME which is viable because of several factors, making it hard for SMEs to raise capital, and thereby making it hard to survive. These factors could be: inadequate security, lack of a track record, credit ratings exceeding 'acceptable' range, and breach of threshold limits.[31] The problem concerning a lack of a track record occurs regularly, an explanation concerning track record is given in paragraph 1.4.2.
The problem of inadequate security is also fairly common. Again the argument goes that the SME might be a start-up company, and therefore does not have enough assets or collateral to provide a level of security that is high enough. However, these SMEs, which have insufficient collateral, are not per definition start-ups. It is an appearance also seen at longer existing SMEs. The breach of threshold limits concerns the breach of certain requirements. Banks have some requirements which the borrowers have to meet in order to receive a loan. SMEs often cannot always meet these requirements and therefore breach a threshold limit.

There are however some factors that influence the likelihood of obtaining bank loans with repayments spread over a longer term. It is for example easier to obtain long maturity bank loans in countries with an interest rate which is low, and in which the growth is high. Another factor is the firm-bank relationship; if it is a close relationship there is more possibility to get such a long-term loan. This effect is seeable especially in countries with a higher concentrated banking sector.[32]
After the crises we have seen last decade it is even harder for SMEs to obtain bank loans. Since loans are so much harder to obtain, it would be desirable for other sources of finance (let us say venture capital) to gain ground, however the study done by the European commission shows us that venture capital shows signs of being cyclical, and since most parts of Europe are in recession, this probably means that this upsurge will not happen at this time.[33] Another reason why such an event would probably not happen is that the capital market in Europe might not be suitable.

1.4.2. Leasing and hire purchase, also known as asset purchasing

After debt finance by banks, this is an important source of external finance. This is an example of secured financing; the finance is secured by the asset that is being leased. This means that it can constitute an effective source of finance to an SME. The advantage is that

[30] Ruis et al. 2009, p.17.
[31] Ruis et al. 2009, p.17.
[32] Ruis et al. 2009, p.17.
[33] Ruis et al. 2009, p.26.

the SME does not cover the money itself but that it is covered by the leased asset, the finance is easier than a purchase, and cash flow is improved. [34]
With respect to the leasing and hire purchase SMEs will probably be more successful going to a lease company instead of a bank since the bank will, before extending a capital equipment loan, commonly want to see financial records dating back two or three years, where the lease company will be comforted with a six to twelve month credit history before approving certain leases.[35]
Experience teaches us that most new companies are not able to provide two or three years of financial records, because of the simple reason that they just do not have this. And if they do, the records might not live up to certain required standards by banks.[36]
A big disadvantage of these means of finance is that it only allows SMEs to acquire certain types of goods or assets. This means that obtaining finance by these means is constricted to the purchase of these certain goods or assets. The means of finance itself and the goods or assets involved are not usable for general working capital purposes, which is an important reason for many SMEs to obtain finance.

1.4.3. Factoring and invoice discounting

Factoring is a sort of asset-based finance in which the value of the accounts receivable is the base of the funding. The factor purchases the receivables at a discount[37] instead of using them as collateral for a loan and thus, the receivables' ownership switches to the factor. [38]
The business gets an advance in cash thereby giving them quick cash flow. The buyer of these financial assets normally gets an interest based service charge[39] and often a factoring commission from the seller (or borrower to the third party). The discount will be paid back once the receivables are collected in full, of course minus the fee.[40]
Because of the fact that the funding is linked to the value of the asset instead of the borrowers' creditworthiness, the asset portfolio should be managed continuously. This should be done in order to make sure that the value of the assets exceed the amount of provided credit.[41]
Some people might think invoice discounting is the same, which is not true. In invoice discounting the discounter screens the clients' company, accounting (and system), customers, production systems, and (overall) creditworthiness. After this the discounter might agree to pay a part or percentage of the outstanding receivables. [42] The control over

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[34] Ruis et al. 2009, p.18.
[35] Ruis et al. 2009, p.18.
[36] Ruis et al. 2009, p.17.
[37] Ruis et al. 2009, p.18.
[38] Yindrichovska n.d., p.1.
[39] Ruis et al. 2009, p.18.
[40] Yindrichovska n.d., p.2.
[41] Yindrichovska n.d., p.1.
[42] Yindrichovska n.d., p.3.

the administration concerning the receivables will be kept by the client itself. Since in this system the discounter only provides the financing service, the fees and interest that have to be paid monthly on the net amount advanced are less than in a factoring structure.[43]
A noteworthy disadvantage is that in order to use these means, a company needs to already have operations from which receivables arise. This means that mostly start-up companies, or companies in the early stage, will not be able to use this since they do not have much account receivables. The fact that they do not have a lot of account receivables is of course a result of the fact that the companies are still in that early stage. In addition, factoring could affect business relations. For example, it could be so that the SMEs' business relationships prefer not to deal with a factor but with the SME itself. I think this is not the best finance solution for SMEs as some cannot apply due to the low level of account receivables, and because SMEs partly rely on strong business relations over the long run. Potentially damaging these relationships has to be avoided as much as possible.

1.4.4. Trade credit

Trade credit often is an element in a business-to-business relationship, and makes it possible to have a delay in payments for certain purchases. The advantage is that it can prove useful in managing the cash flow and in addition takes away some need for short-term bank credit.[44] There are also certain disadvantages of which I will mention some.
One of these disadvantages is that when the SME fails to pay in time it might gain a negative reputation with other companies and, in a more general sense, the credit history will be affected in a negative way. This may prove disadvantageous when the SME needs other credits such as a bank loan or other means of finance described in this chapter. Trade credit also might not constitute a direct source of cash i.e. to fulfill other obligations.
Another disadvantage is that SMEs which are start-ups or early stage companies might find it hard to achieve trade credit because they do not have a solid (trade) relationship with the other business yet. The other business might therefore not trust the SME concerning the repayments. By this I mean that the other businesses will probably demand immediate payment as they are not sure whether they will receive payment or not, when a relationship in which the SME is trusted by the company has not yet been established.
In addition must be said that the amount of trade credit is limited, and as mentioned also limited to the relationship to which it applies.

1.4.5. Crowd funding

Crowd funding is relatively new in the world of finance because of recent technological developments and therefore it is, even though it is gaining in popularity, still relatively small. Basically it consists of asking a lot of people, which can be either sophisticated, professional

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[43] Yindrichovska n.d., p.3.
[44] Ruis et al. 2009, p.18.

Investors or public, unsophisticated Investors, to make a small or medium-sized investment.[45] Involved are of course the entrepreneurs who want to gather financial support from interested investors. And of course there is the 'crowd' of investors who are expecting a reward for the risk they are taking.[46] Noteworthy is that these investors by their selection of projects they find interesting or which seem to be promising, invest in (in a certain way much like venture capitalists), are helping to produce the eventual output.
Another player is the organization which brings together the entrepreneurs and the investors by crowd-funding mechanisms: the crowd-funding organization.[47] Crowd-funding is a pretty new, and in my opinion, revolutionary way of finance, however, as anything, it also has its disadvantages. An example of such a disadvantage exists in the fact that many SMEs do not have luxuries as time and money which are elements that could be needed in a crowd-funding campaign, making possible investors aware of your plans. The campaign can be very intensive and also potentially costly.
Out of this disadvantage, another one emerges. The implied publicity the campaign causes, also invites future competitors to start competing with the SME. For many SMEs it is important, especially in the early stages, to keep the (young and new) projects stealthy.[48] The level of desired secrecy does not coincide with the goal of the campaign, which is making your product known with possible investors.
Another disadvantage is that it is not sure whether the financial goal will be achieved by crowd funding because there are many investors which are investing relatively small amounts, the question is how much will be raised.[49] Of course there are more disadvantages which are not treated.

1.4.6.Mezzanine finance

Mezzanine finance is mostly used by already existing companies seeking to expand, in the light of exhibition 1 it is used in the emerging growth and the development stage.
It is a combination of debt and equity finance and therefore this is called a "hybrid" which shares characteristics of both types of finance.[50] It is often used to fill up a funding gap between senior debt and equity. This financing gap is often created because of the fact that companies discount their accounts receivable, fixed assets and inventories at greater rates than before. This happens because businesses are often afraid that their values will not be realized in the future.[51] Another reason is that there are more intangible assets on balance sheets and, a third reason being regulations and defaults. Explanatory for the last reason is

[45] Ordanini et al. 2011, p. 444.
[46] Ordanini et al. 2011, p. 445.
[47] Ordanini et al. 2011, p. 445.
[48] Jones 2012, p.1.
[49] Jones 2012, p.1.
[50] Bank for International Settlements 2012, p.6.
[51] Silbernagel & Vaitkunas 2010, p.2.

that because of the economic environment banks have capped the maximum amounts of debt a company can have.[52]

Mezzanine finance is more risky than debt finance, but not as risky as for example venture capital. An advantage of this type is that it is suitable for customization in order to live up to the financial needs of different businesses.[53] There are multiple forms such as the participating loan, subordinated loans, and “silent” participation.

The subordinated loan is the most used loan and has a fixed interest rate. It is unsecured and has a lower ranking than senior debt in case of insolvency, providers however are ranked higher than equity investors.[54]

Participating loans are the same as regular loans except there is no fixed return. The payback is based upon results of the business. Even though the provider is sharing in the profits, there is no ownership relation and, there is contractual exclusion of participation in losses.[55] Sometimes, in a different structure, there might be an equity component such as the “silent” participation, or options for the investor to obtain an equity stake in the business. This possibility of converting the loan in an equity stake will normally be used when the business is either successful enough to desire an equity stake, or if it is defaulting in making payments concerning the loan.[56] It is possible to secure mezzanine finance however, in the light of recovery of the capital in the case of a default, it is ranked lower than senior debt.[57]

1.4.7.Business angels

Business angels will seek to get an equity stake in small businesses in growth, by investing their own money. They are usually persons with high net worth[58], and are a sort of informal VC (venture capital) investors.[59] When they invest they will usually work with relatively small amounts of money.[60] Since they target small companies, usually in an early stage, their activity is best noticed in the seed phase and the start-up phase[61]. Their targets are usually high-tech start-ups.[62]

Among the business angels there are the ones who seek only to supply funding, but there is also a group who might add more than just that, such as networking introductions or advice. Depending on the individual this can either be swapped for profits, equity and some might even do it for free. Added value for these start-up companies could be: entrepreneurial

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[52] Silbernagel & Vaitkunas 2010, p.2.
[53] Bank for International Settlements 2012, p.6.
[54] European Commission 2007, p. 6.
[55] European Commission 2007, p. 6
[56] Bank for International Settlements 2012, p.6.
[57] Bank for International Settlements 2012, p.6.
[58] Bank for International Settlements 2012, p.24.
[59] Tsukagoshi 2008, p. 427.
[60] Bank for International Settlements 2012, p.24.
[61] Tsukagoshi 2008, p. 427.
[62] Bank for International Settlements 2012, p.24.

experience, business know-how, contributed commercial skills and contacts by the angel investor.[63] Many Business Angels have been entrepreneurs as well, and can therefore take a mentoring role in the process.[64] The main difference between Venture capitalists and Business Angels is that the venture capitalist acts as a mediator between the entrepreneurs and the investors, while the Business Angels invest their own money and are therefore not accountable to third parties for the investments.[65]

1.4.8.Venture Capital

Intertwined with this type of capital investment is the investment in management expertise and to add to the credibility of the company, it is mainly injected in fast-growing companies with potential of growth.[66]
Important to know is that Venture Capital is provided by professional enterprises or private persons which do this full-time and will usually want board membership as part of the investment monitoring, and for fulfilling a mentoring role.[67]
The main difference between bank and Venture capital finance is that the venture capitalists invest cash, and aims to get a share capital minority in the company as a return where banks want scheduled repayments of principal and interest. In the past, the venture capitalists wanted the investment realized in a period of five years with high returns as a goal.[68] Currently this timespan has increased dramatically.
Usually this is achieved by selling their shares back to the business, public market float, or trade sale.[69]

The venture capital cycle is a complex appearance, and has backed some of the most successful high-technology companies such as: Microsoft, Apple computer, Compaq and Cisco systems. Not all of the venture capital is going to technology firms, but most of it is.[70]

Structuring of funds and capital raising by Venture Capitalists is very complex, for most people not involved in this sector it is even harder to comprehend as it depends on many different factors.[71] As often said there are multiple sides to any story, in my opinion same goes for this topic. The venture capitalist who wants to make money has different ideas, incentives and plans than, for example, a relatively young and inexperienced entrepreneur who wants to attract capital in order to fulfil a dream of realising his business plan successfully. The relationship that can result out of these desires, and the differences or

[63] Tsukagoshi 2008, p. 427.
[64] Heukamp et al. 2006, p. 3.
[65] Heukamp et al. 2006, p. 3.
[66] Ruis et al. 2009, p. 19.
[67] Ruis et al. 2009, p. 19.
[68] Ruis et al. 2009, p. 19.
[69] Ruis et al. 2009, p. 19.
[70] Gompers & Lerner 2001, p. 149.
[71] Gompers & Lerner 2006, p.23.

asymmetries that may appear, are however just a dot on the tip of the iceberg called the venture capital cycle.
Understanding the process of partnership structuring (the venture capital firm) and fundraising is intertwined with the beginning of understanding the size, magnitude and structure of this "iceberg" called the venture capital cycle.[72]

Context
The situation is that venture capital creates opportunities by providing capital to firms which might otherwise not get any finance or would have difficulties finding any because of the problems mentioned earlier in this chapter (e.g. little collateral etc.).[73]These firms also operate in difficult markets as these markets are either completely new (due to the innovativeness of the product line of the businesses) or tend to change very rapidly.
According to Silviera and Wright (2006), another reason for the fact that it is hard to obtain (for example) bank loans for these companies is that it might be difficult for the 'non-experts'(bank employees) to evaluate the entrepreneurs' ideas.[74]
On the background these mostly young and small firms are plagued by information asymmetries between the entrepreneurs and investors and therefore by high levels of uncertainty.[75]

Summary of the process
Venture capital is a form of private equity. Venture capitalists operate for funds and are specialised in finding, assessing/evaluating and targeting projects that potentially have a high return but which on the other hand are also high-risk.[76] The 'cycle' will normally start with raising funds after the fund itself has been created.[77] Because, in order to finance other, potential high return ventures the VC is going to need finance himself. The venture capital fund will often be a limited partnership in which the investor is the limited partner, and the venture capitalist is the general partner.[78] The Limited Partnership typically has a limited life-span of 10 years.[79]
The money for the fund is raised from private and institutional investors who are interested in supporting high-potential (and innovative) early stage companies.[80] For institutional investors the investment in one of these funds may be very risky. This is because there is a friction between the power of the staff of the institutional investors and the investments

[72] Gompers & Lerner 2006, p.23.
[73] Silviera & Wright 2006, p. 2.
[74] Silviera & Wright 2006, p. 2.
[75] Gompers & Lerner 2001, p. 154.
[76] Silviera & Wright 2006, p. 2.
[77] Mendoza & Vermeulen 2011, p. 1.
[78] Gompers & Lerner 2006, p. 27.
[79] Gompers & Lerner 2006, p. 52.
[80] Mendoza & Vermeulen 2011, p. 1.

done by venture capitalist in high-risk bearing, but potentially high-return producing, young companies.[81]
The staff of even the biggest institutional investors is relatively small, they can often be counted on two hands and they carry the responsibility of billions of dollars in investments every year. The venture capitalist on the other hand is searching for the opportunities, but thereby often engages in risky investments.[82]
The projects which apply for funding, are started by the entrepreneurs who will start a business based on an idea. The venture capitalist will seek to invest solely in the high potential businesses created by the entrepreneurs.[83] The investments can be done by the purchase of equity of the firm or by buying equity-linked stakes.[84]
Even well important is that the venture capitalists are experts in implementation. Instead of just giving out money to entrepreneurs, a partnership is entered into by the entrepreneur and investor.[85] They are educating and guiding the entrepreneurs by being actively involved in the development of the project, participating in management, and monitoring the entrepreneurs. When the venture capitalist is of the opinion that the project is mature enough, and evaluation by others is easier as well as it is more easily operated by others, the venture capitalist will seek an exit to cash-in.[86] The venture capitalist will get their returns in exit transactions since these early-stage (and often high-tech) firms usually cannot pay dividends or debt interest due to a lack of cash flow.[87] In an Initial Public Offering the venture capitalist will keep his shares for a while to send out the right signals to the market, after a while they will seek for the cash-out. This is also referred to as a 'lockup' covenant.[88]
A large amount of the returns are re-channelled to the initial investors, which can sound the bell for the circle to start over again, and form a new venture capital cycle.[89] Venture capital can be an important source of external finance for SMEs especially for high potential start-up SMEs. However it should be said that Venture Capital accounts for a relatively small proportion of the external finance for SMEs in Europe.[90]

1.5.What are the flaws in the current variation sources of finance for SMEs?

A distinction should be made in this topic; before, and after the financial and economic crisis. Most flaws have already been present before the crises, but are now more dominant. Of course there are numerous flaws and causes for them so I will only address a few

[81] Gompers & Lerner 2006, p. 24.
[82] Gompers & Lerner 2006, p. 24.
[83] Silviera & Wright 2006, p. 2.
[84] Gompers & Lerner 2001, p. 145.
[85] Silviera & Wright 2006, p. 2.
[86] Silviera & Wright 2006, p. 2.
[87] Cumming & Johan 2008, p. 2.
[88] Gompers & Lerner 2006, p. 423.
[89] Mendoza & Vermeulen 2011, p. 1.
[90] Ruis et al. 2009, p. 5, 16.

possibilities. I would like to add that I think there are also several solutions to diminish the effects of these flaws one of which is government intervention, and another one is to enlarge the variation of finance sources. A problem is that banks are reluctant to provide loans to SMEs. In this thesis I will try to locate some of the problems why originators are reluctant to lend to SMEs and to securitise these loans.

To start off there are some market failures, which mainly are linked to the problem of asymmetric information. The asymmetric information problem can relate to multiple relationships. For example: In the relation of a bank (as a lender) and the SME, being the borrower, banks want to know whether the SME bears high risk or low risk. If the banks would try to distinguish the entrepreneurs they would usually make significant screening costs to distinguish the high risk from the low risk.[91] Financial track records are often required to diminish most of these searching costs and same goes for security, being collateral. Hence the decision to lend taken by the financial institution is based on these things. And, in a lesser degree, also taken under consideration is the chance of success or the business' viability.[92] The reason for this is that it is very difficult to make a forward-looking prediction of the value of the company when you have so few information and such a small track record of operation. The conclusion is that some young SMEs with high chance of success are unable to get the finance they need because they do not have a track record or collateral. [93]

In the demand side for finance there are also market failures which are linked to information, since it is a matter of supply and demand, these problems are combined with those on the supply side. An example of a failure on the demand side is when a founder does not know where he can get funding, and does not know which are the available sources thereof. This is especially the case concerning equity finance.[94] Another possibility is that he might not have the skills to convince possible investors that his company is an investable opportunity, thus his presentation is a failure. Another imperfection is when an SME or owner does not realise the benefits that attracting of (extra) finance has for their SME. Same goes for owners who underestimate the chance of success in fund raising, leading them to not even apply at all.[95]
Another financing gap is created by the relatively small amounts of equity that goes to SMEs. Again this comes for the account of information asymmetries; an investor has to assess whether an SME is viable and/or will be profitable in the future and with this come the costs

[91] Bank for International Settlements 2012, p. 9.
[92] Bank for International Settlements 2012, p .9.
[93] Bank for International Settlements 2012, p. 9.
[94] Bank for International Settlements 2012, p. 12.
[95] Bank for International Settlements 2012, p. 12.

for doing due diligence. This is normal, these transaction costs however are often fixed with a little room for deviation depending on the investment size.[96] The consequence is that the transaction costs for smaller investments are (relatively) high compared to the size of the investment.[97] This leaves possibly viable SMEs with chances of success unable to raise equity finance as equity investors will seek to make fewer investments which are larger, in more matured companies (with less risk). The result is a finance gap for SMEs in the early stage trying to obtain venture capital.[98]
These are a few market failures but there are more, there is for example also a financing gap in the growth capital supply.[99]

Furthermore, the department for Business Innovation & Skills states that equity finance to SMEs with great potential of growing into a successful company is under-supplied. This is a possible effect of the fact that private investors make decisions for themselves. They do not think of the positive externalities that transfer of knowledge and innovation carries when making the choice to invest or to not invest in VC. When there is no investment in venture capital funds, there is as a consequence a more limited supply of VC investments in start-ups, leading to a supply shortage of equity finance.[100]

As a result of these market failures, the supply side of both equity and debt of finance to viable SMEs is affected, resulting in the refusal to provide finance to possibly viable companies.[101] These information asymmetries or market failures could be magnified in economic environments where uncertainty runs the show as lenders are becoming increasingly risk averse.[102] One of the most day-to-day examples are the banks. Banks are often not lending, and when they do, they could be lending too little. Banks see SMEs as risky and therefore SMEs have a bigger chance of rejection of their demand for finance. If they succeed in obtaining the finance they will have to meet higher requirements. From the view of the bank this is legitimate, certainly when there is inadequate security or collateral, limited information and limited solvability. The banks cannot enter in risky loans that may lead to losses in the future. This has been an issue before the crisis, but since the crises this flaw has really begun revealing itself.[103]

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[96] Bank for International Settlements 2012, p. 9.
[97] Bank for International Settlements 2012, p. 9.
[98] Bank for International Settlements 2012, p. 10.
[99] Bank for International Settlements 2012, p. 11.
[100] Bank for International Settlements 2012, p. 13.
[101] Bank for International Settlements 2012, p. 8.
[102] Bank for International Settlements 2012, p. 8
[103] de Swaan et al. 2011, p. 2, 3.

2. The securitisation of loans

As the name predicts, securitisation is about the creation and issuance of securities. In this structure, cash flows are generated by separate pools of assets which take care of the payments of principal and interest that are attached to the issued bonds or notes.[104]
Instead of waiting for a loan to be paid off, originators can have immediate cash , generated from the securitisation of such assets and the sale of the issued securities to investors.[105]
Securitisation is typically over financial assets. [106] In this thesis especially the securitisation of loans is relevant, but it is also possible for certain other assets; consider, for instance trade receivables, leases or real estate goods.
The financial assets generally provide a predictable stream of payments divided over a period which can be converted into a big pile of money at once by securitising the assets, this is one of the elements that make the assets suitable for securitisation.[107]

2.1. The securitisation

Securitisation is a commonly used transaction with certain advantages to the participating parties. In the basic transactional structure an SPV (Special Purpose Vehicle) is formed, for the single purpose of securitisation,[108] and is normally thinly-capitalised. The SPV can be located offshore (which is often advantageous because they can be located in jurisdictions which have low taxes or sometimes even none). Of course there are other regulatory aspects that will be looked at as well, such as corporate costs, capital requirements et cetera.[109]
There are many different thinkable variations of securitisation structure, and the most basic form is that in which there is the "true sale". This chapter will be limited to the true sale and synthetic securitisation which is used regularly.[110]

An owner of receivables, named the originator, sells these to the SPV. The SPV issues conventional bonds or note to sophisticated investors and, in that way, the price for the purchase of the receivables is financed.[111] The investors are granted security over the receivables, so their investments are asset-backed. The money borrowed by the SPV from the sophisticated investors is repaid out of the proceeds of the earlier purchased receivables.[112] The transaction ends when the borrowers have paid back all the securitised loans.[113]

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[104] Legro 2009, p. 18.
[105] Legro 2009, p. 17.
[106] Legro 2009, p. 18.
[107] Legro 2009, p. 17.
[108] Wood 2010, p. 458.
[109] Wood 2010, p. 459.
[110] Legro 2009, p. 18, 29.
[111] Wood 2010, p. 450.
[112] Wood 2010, p. 450.
[113] European Commission 2006-2007, p. 7.

The receivables have to be sufficient in order to guarantee that the investors are being paid back (in time), if this is not the case, the shortage probably be covered by so called "credit enhancements".[114] Credit enhancement also helps to protect the SPV from insolvency.[115] For more information and a better insight in credit enhancement see paragraph 2.1.1.

The advantage for the originator in this transaction is that the purchase price is paid immediately on sale, instead of periodical payments, providing capital relief and liquidity. Banks are obliged to hold capital for the credit risk on their balance sheet. By securitising they need to hold less capital because the credit risk is being removed from the balance sheet.[116] Important to know is that the originator does not hold the shares of the SPV. This can be done by a charitable trustee for example. In this way the SPV does not have to be consolidated on the balance sheet of the originator because it is not a subsidiary. Important is that the SPV is set up as a legal entity which is separated, so there is no responsibility for the originator concerning the SPV its obligations.[117] This is described in more detail further in this chapter.
Note however that some depends on the rules of the country of the originator. Participations up to a certain amount may be seen as not necessary to consolidate.

The originator is not out of the picture as it is authorised by the SPV to cash the receivables. This of course happens on the SPVs' behalf. Out of the collected receivables principal and interest on the issued notes is paid by the SPV. The "servicer" (originator) receives the servicing fee. During the process, the proceeds are being invested by the SPV.[118]
The receivables' surplus income is paid to the originator (profits for the originator). Often this is under the guise of an interest rate (a high one) over a subordinate note, under the guise of a servicing fee, or under another guise, and is not needed for the repayment to the note holders. [119]

Another advantage is that it implies risk management of the balance sheet; there are less assets that are considered to be risky on the balance sheet which improves solvency. Last but not least, securitisations also allows originators (read banks) to obtain relatively cheap funding for longer periods of time.[120]

[114] Wood 2010, p. 450.
[115] Wood 2010, p. 466.
[116] Legro 2009, p. 20.
[117] Wood 2010, p. 450.
[118] Wood 2010, p. 450.
[119] Wood 2010, p. 451.
[120] Legro 2009, p. 21.

2.1.1 Credit enhancement

The credit quality of a transaction is often increased by using credit enhancement, allowing the quality of debt to be higher as compared to collateral which is underlying and lower rated.[121] It is a sort of reassurance that the obligation will actually be paid or honoured by the borrower, in this case the SPV.
A major advantage is that it could influence credit rating agencies so they might give the transaction possibly a higher rating. It is normal for a certain transaction to have a combination of several means of credit enhancement.[122]
The issuer usually has a specific rating in mind it would like to achieve. The degree of credit enhancement used is based on the specific rating that the issuer has in mind. A logical consequence is that the ratings get higher as the credit enhancement level is higher.[123]
A division of credit enhancements is possible into two main groups: external and internal. The exhaustion of external enhancements happens prior to the degrading of the internal enhancements in the case of losses in the portfolio that is underlying. This means that the tranches (a means of internal enhancement) are affected only after the external enhancement has been exhausted, [124] as the external enhancement is "eaten first".
Some examples of credit enhancement are: liquidity facilities, guarantees, guaranteed investment contract, subordinated loans/deferred prices, reserve accounts and interest swap.[125]

2.1.2. Tranching

This happens in nearly all securitisation transactions.[126] Tranching is dividing the notes in different orders based on their risk-return profile, forming the ´capital structure´.[127] For example there can be junior notes with low rating or no rating at all (normally originator retains these), senior notes with AAA rating, and often some notes in between being mezzanine (not to be confused with mezzanine as in the first chapter).[128] Junior notes are more risky and therefore often more attractive to speculative investors.[129] In addition; the interests on the securities are ranked, the junior notes receive higher interest than the senior notes.[130] The term AAA means that there is a low chance of default and thus is a highly secure investment.[131]

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[121] Legro 2009, p. 23.
[122] Legro 2009, p. 23.
[123] Legro 2009, p. 23.
[124] Legro 2009, p. 24.
[125] Wood 2010, p. 466.
[126] Wood 2010, p. 453.
[127] European Commission 2006-2007, p. 6.
[128] European Commission 2006-2007, p. 6.
[129] Wood 2010, p. 453.
[130] Wood 2010, p. 453.
[131] European Commission 2006-2007, p. 7.

The senior notes represent the largest share of the capital structure, often between 80% and 90%, with variations subsidiary to the loan pool quality.[132]
Incoming cash originating out of the SPV portfolio are distributed according to the waterfall principle. This means that the notes' priority settings are precisely defined and thus show who is first in line to get paid. [133] In the case of profits the senior notes are the first to be paid, and the junior notes last.[134]

If the senior notes have a value of 10 million Euro's, the principal and interest proceeds from the receivables will be assigned to the senior notes first until the 10 million Euro's has been repaid entirely, when this is done the lower tranches of notes are started being repaid.[135]
In the case of losses, the junior tranches act as a protection for the higher tranches.
When the losses exceed a certain threshold based on a percentage of the volume of the pool, the exceeding losses will be borne by the mezzanine tranche. The result is that the senior notes can achieve a higher rating.[136] The main goal of tranching is getting as much as available finance as possible, and to achieve the highest possible rating on the senior notes as the junior notes bear the initial losses.[137]
An originator often has an idea about how the tranches should be divided and what ratings they should have. Credit rating agencies will define how much credit enhancement is needed to actually realise the originators' idea.[138]

2.2. Different securitisation structures

The most seen structure is the one in which the loans are sold to an SPV (as described earlier).[139] The transaction of SME loans is pretty much the same as other securitisations, but with SME loans as underlying assets.[140]

There is also the "synthetic securitisation" which is (also) structured in a way that the asset credit risk, and not the actual asset is transferred to investors. This method is not uncommon and is often used in SME loan securitisation.[141] Noteworthy is that in the "true sale" there is less risk arising from defaulting counterparties; there is less counterparty risk.

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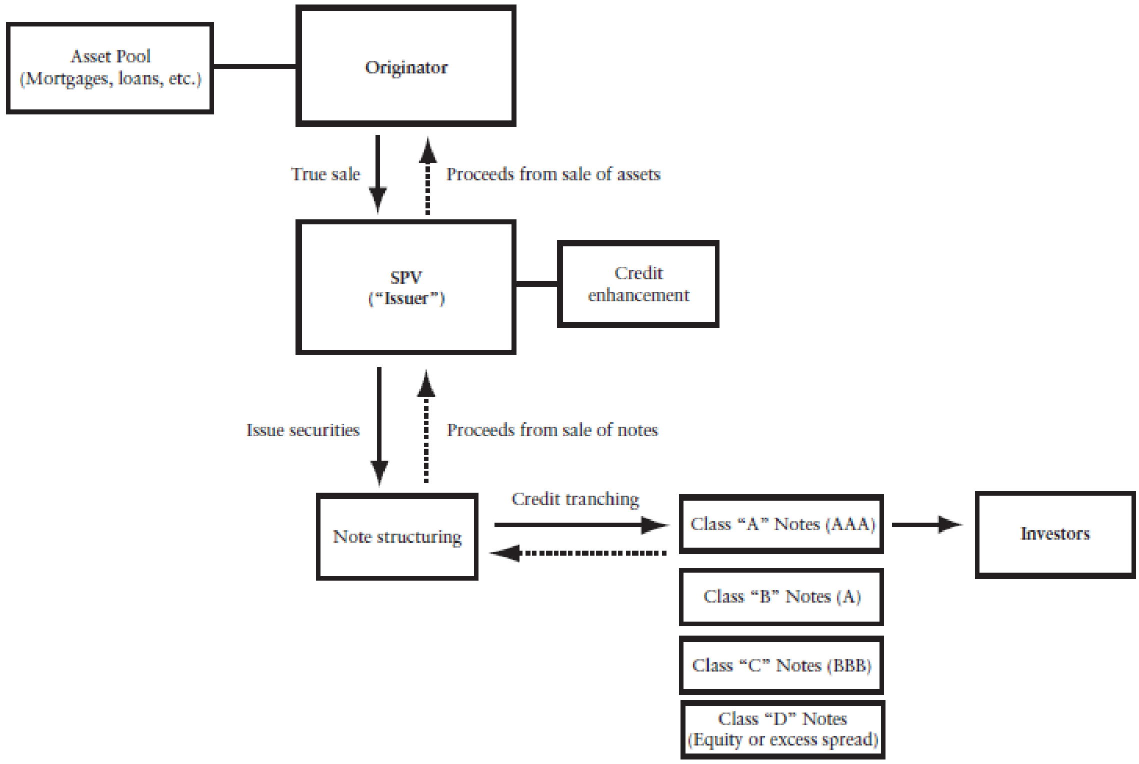
[132] European Commission 2006-2007, p. 6.
[133] European Commission 2006-2007, p. 6.
[134] Wood 2010, p. 454.
[135] Legro 2009, p. 22.
[136] European Commission 2006-2007, p. 7.
[137] Wood 2010, p. 453.
[138] Legro 2009, p. 23.
[139] Wood 2010, p. 458.
[140] Legro 2009, p. 29.
[141] Legro 2009, p. 29.

In addition, the possible base of investors for the "true sale" is bigger. As certain investors and financial institutions have a cap on how much credit derivatives can be used.[142]

Exhibition 3: The process of the most common type of securitisation ("true sale").

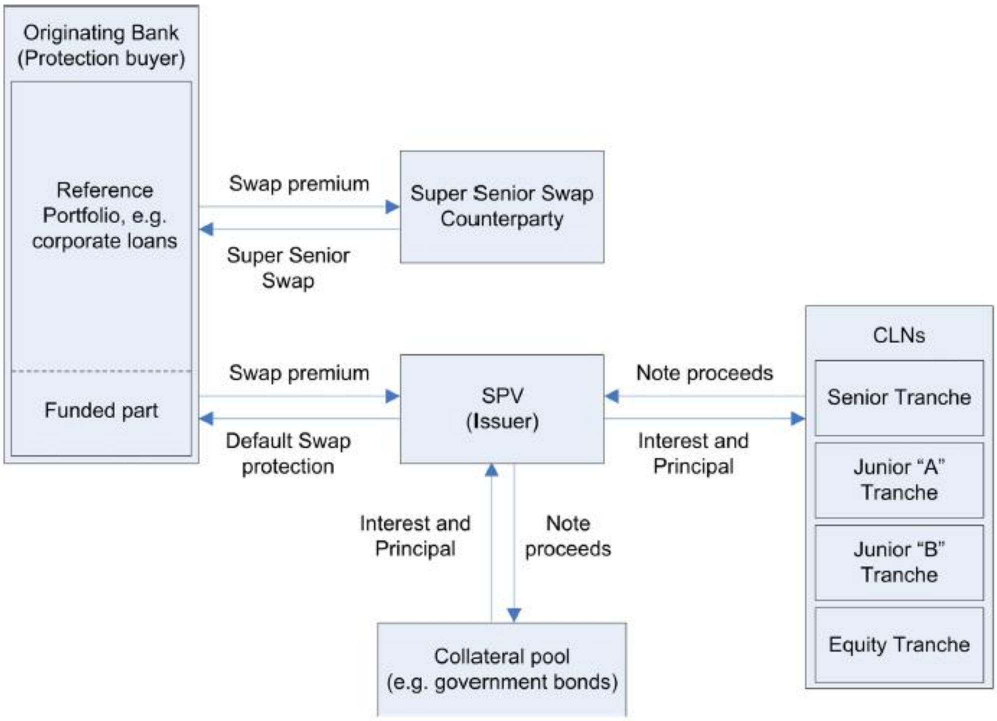


Source: Fabozzi et al. 2006, p. 70.

It can be roughly divided in unfunded, partially, and fully funded. To illustrate: if a transaction is fully funded, the portfolio's whole credit risk is being transferred via a credit default swap by means of Credit-Linked Notes or securing the obligations of the "seller of the protection" with collateral.[143]
In the case of CLNs, the investor (also the seller of the protection) pays any obligations it has at the commencement of the transaction.[144]
For unfunded transactions, credit default swaps accounts for the entire structure, no payment of obligations is being done at commencement, and there is no backing up by collateral. In the case there is a credit event, the obligation of the investor is settled. The partially unfunded structure is a combination of the funded and unfunded.[145]

[142] Legro 2009, p. 34.
[143] Legro 2009, p. 29.
[144] Legro 2009, p. 30.
[145] Legro 2009, p. 30.

Exhibition 4: For illustration of the discussed elements, an example of a partially funded structure.



Source: Legro 2009, p. 31.

Most of the credit risk is transferred through the Super Senior swap (credit default swap), this is the part that is unfunded.[146]
In the other CDS (the swap), the SPV makes a guarantee that it will pay losses (due to defaults concerning the loans, e.g. insolvency or if they are not being paid) the originator bears on its loans. The SPV receives payments from the originator, equally high as a part of the interest received from the loans by the originator.[147] In short this means that the originator is paying a fee for the guarantee of the SPV and in return, the SPV pays potential losses on the loans. Notes are issued to investors by the SPV in order to pay these possible losses. This is under the condition that in the event there are losses, the SPV pays these, consequently leaving the investors to receive less principal. The first group who suffers are the junior notes, and later the senior.[148]
The SPV invests the proceeds originating from the notes in secure investments e.g. government bonds. The investors are repaid out of the protection-fee the originator pays (paid from interest on the reference loans) to the SPV. Also this is done by interest on the bonds in which the SPV invested.[149] The obligations of the SPV towards the originator have to be covered, for that reason the originator has a charge on all the SPV's assets (so also the bonds).

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[146] Legro 2009, p. 30.
[147] Wood 2010, p. 460.
[148] Wood 2010, p. 460.
[149] Wood 2010, p. 460.

So basically the originator receives a guarantee by the SPV, insuring the loans. The note holders insure the loans through the SPV.[150]

The consequence of using this structure is that the assets are not per definition transferred from the balance sheet, leading to the use of this structure primarily as being the transferral of risk over funding of the balance sheet. It allows the credit risk exposure being removed while retaining the assets, diminishing administrative fuss. This method may be preferable for (regulatory) capital relief and risk management.[151] Besides the administrative advantage, the super senior part requires no funding, transaction time is shorter, because of the administrative advantage and low legal expenses the transaction costs are relatively low, using credit derivatives enables more flexibility and so more.[152]
It is also possible to transfer the receivables to a trustee instead of the conventional SVP, this is however limited to certain jurisdictions which have legislation on the trust.[153]

Another variation to the true sale consists of the possibility of sub-participations. This is done in the situation where the receivables cannot be transferred because of some reason, for example when debtor consent is required. In this structure the SPV gets sub-participations in the loans.[154]
Investors lend the SPV money (through bond issue), which is used for a deposit placement by the SPV to the originator.[155] The deposit (interest included)is repaid by the originator only if itself receives principal plus interest from the loans. So if the originator is unable to collect the receivables, the risk of never getting the money back is for the SPV and thus also its investors. This structure lacks some of the advantages that securitisation provides, where it is not advantageous for the balance sheet, nor is it helping originators avoid certain requirements for capital adequacy.[156]

Other variations of structures are "securitisations of securitisations" in which notes of different SPVs are sold by investors to a different SPV, managed securities, the repackaging of securities, and the case of several originators in which the receivables of multiple originators are sold to one SPV.[157]
The managed securitisations are much alike investment companies; the SPV assigns a collateral manager which will make investments in debt obligations.[158]
In the repackaging, debt securities are issued by the SPV to investors. The SPV has taken over bonds from the originator, and its these bonds that are the security for the debt securities.[159]

2.3. Necessities

In order to make the securitisation realizable in a good way there are some requirements that need to be lived up to. Some of these have already been mentioned before; The notes

[150] Wood 2010, p. 460.
[151] Legro 2009, p. 29.
[152] Legro 2009, p. 33.
[153] Wood 2010, p. 459.
[154] Wood 2010, p. 459.
[155] Wood 2010, p. 459
[156] Wood 2010, p. 459
[157] Wood 2010, p. 461, 462.
[158] Wood 2010, p. 461.
[159] Wood 2010, p. 461.

used to finance the price paid by the SPV must be covered by receivables that are sufficient to cover them. If this is not the case the difference has to be compensated by some sort of credit enhancement.[160]

A second requirement is that the transfer of the receivables to the SPV should be as easy as possible, without unnecessary obstacles. Expenses are troublesome in this regard and same goes for unnecessary formalities or any debtor-consent needed. Another problem could be debtor set-offs so it is important to diminish the risk of this.[161] A set-off is a situation where a debtor and a creditor owe each other money (of course the debtor owes more), in matters not related to each other, and settle this. For example if the debtor owes the creditor 10€, and the creditor owes the debtor 2€ concerning a different matter, they settle that the debtor owes 8€. If set-off is not excluded, and debtors are able to set off certain claims the originator owes to them, additional credit enhancement will be necessary because the set-off will diminish the receivables.[162]

A third requirement is the "true sale" for several purposes: originator bankruptcy, accounting rules, capital adequacy (regulatory), and security interests (may not be classified as an originator granting a security interest). However, rules for knowing when there is a "true sale" is dependent on the circumstances and differs from case to case. [163]

2.4. The true sale

In the previous paragraph some purposes for the true sale were given. An example concerning this is that the sale should not be done with the purpose of being sale as a security interest. This means that the receivables should actually be transferred in a complete and final way from the originator to the SPV, setting the originator free from liabilities on the assets (and notes).[164] Logically this means that the seller also lost control; from the sale on, the SPV has full dominion and control over the asset and can do with it whatever it desires. When the seller still has some control over the asset, it could be seen as its property and therefore, in the case of insolvency, available for creditors.[165] It is of great importance that the asset is "bankruptcy remote" from potential originators' bankruptcy as Wood (2010) states. In addition, there is no revocability of the transfer in case the SPV goes bankrupt.[166]

In order to achieve this bankruptcy remoteness the debtors must have received a notice of the transfer, to prevent the assignment from being void or voidable in case of an insolvency of the seller (in some jurisdictions this is the consequence of not giving notice to the

[160] Wood 2010, p. 452.
[161] Wood 2010, p. 452.
[162] Wood 2010, p. 465.
[163] Wood 2010, p. 452, 453, 218 , 465.
[164] Wood 2010, p. 452.
[165] Wood 2010, p. 468ff.
[166] Wood 2010, p. 468ff.

debtors).[167]

Another requirement for achieving the remoteness is that, in case of the originator going bankrupt, the SPV may not be merged, consolidated or fused (not meaning balance sheet consolidation) with the seller of the receivables. This means that the liabilities and assets would be partly on behalf of the seller which is (as said before) not supposed to happen.[168]

This bankruptcy consolidation is not a real threat since it is very rare as the documentation as well as the implementation usually ensures the separateness of the originator and the SPV.[169] Also important is that, in the case of insolvency of the seller, when it is acting as servicing agent, no delay or material losses in the retrieving of the funds is present. Another requirement is that the payments, in case of insolvency of the seller, to the SPV by the seller must not be able to be retained as a preference. The same goes for undervalued transactions[170] as these actions break the bankruptcy remoteness.[171]

[167] Wood 2010, p. 464, 471.
[168] Wood 2010, p. 471.
[169] Wood 2010, p. 471.
[170] Wood 2010, p. 471.
[171] Wood 2010, p. 471.

3. The rationale of SME securitisation

3.1. SMEs in trouble

As we have seen before there are some problems that SMEs may encounter such as their dependency on finance and financing gaps which occur. In times of economic deterioration their problems might grow bigger. For example SMEs are by nature hard to downsize since they are not too big to begin with. For larger companies this is a less pressing issue. Another problem for SMEs is that their individual economic activities are not so diversified and, because of their size, their financial structure is often weaker. In addition, as mentioned before, SMEs often lack a credit rating and if they do, it is often low. [172]
In the first chapter some problems were highlighted concerning the attraction of finance by SMEs. The link between the first chapter and the second chapter is that securitisation techniques can possibly be used to make it easier for SMEs to obtain finance.
Bank loans are hard to obtain by SMEs for several reasons of which a few are: the disappointing economic prospects of SMEs, the cooling down of lending between banks which is thereby causing the capital to cost more, and thirdly, constraints to, or strengthening of the balance sheets.[173] Of course there are more factors that have a part, such as increasing risk aversion by certain financing parties and the earlier mentioned problems such as lack of assets for providing security to lenders, and the difficultness to predict revenue streams SMEs will obtain and/or pay.
Since it is hard to obtain loans, the amounts of provided loans might be boosted by using securitisation techniques. The goal of this chapter is to show that there is, at least in theory, room for growth in the use of SME loan securitisation and why this is so.
SME loan securitisation has proven to be an effective addition to the finance world. Problematic however is that it does not seem to not be attractive (anymore).

3.2. Economic downturn and regulatory changes affecting the entire securitisation market

Even though the main focus of this thesis is to look at regulatory initiatives and their effects, it is important to see this in context, which is bluntly: a really bad economic environment.
Added to this is the fact that even before the crisis hit, structural changes have been made in regulations. These changes were affecting the banking sector and were constraining the financial intermediaries which were lending to SMEs and thereby meant a decrease in SME lending.[174] The results of these pre-crisis changes are pro-cyclical whereas some of these regulations are diminishing SME lending.

3.2.1. How securitisation of SME loans can improve the access to finance

By securitising, banks are in fact delinking the credit exposure which is on their balance from the loan origination. SME securitisation could improve access to finance because banks are able to provide more loans with a certain, limited capital base. When a portfolio is securitised, the capital will be freed again and can be re-extended in the form of new loans to other SMEs. In this way, the banks do

[172] OECD working party on SMEs and Entrepreneurship 2009, p. 6.
[173] OECD working party on SMEs and Entrepreneurship 2009, p. 7.
[174] OECD working party on SMEs and Entrepreneurship 2009, p. 24.

not encounter certain concentration limits when granting loans to these other SMEs.[175] Banks which focus on, for example, SME loans particularly and/or on a certain region especially, seem to benefit from this, as it allows them to improve their customer relationships without limitations based on any constraints to the balance sheet and by a better use of their credit expertise. Many banks engaging in this cycle are enabled to gain a higher return on equity
When this happens, and the bank is getting more successful in this, the more probability of the banks' business with SMEs is able to expand.[176]
In addition, securitisation provides banks with higher ratings with a greater diversity of sources of funding. This is especially the case for funding over a long-term, enabling them to be more competitive in the field of lending to SMEs. In the end the SMEs will be better off since they will benefit from this competition as the conditions for funding will improve.[177]
In addition, in many cases, better rates of funding are offered through securitisation compared to banks that have standalone ratings. This is often the case for at least the most senior notes of the involved portfolios. [178]
Furthermore, securitisation could also change bank behaviour as it incentivizes banks to lending behaviour that is less cyclical. In a downturn of the economy, the supply of loans is could very well be reduced due to the fact that banks encounter write offs and they have to comply with capital requirements that are rising. In that situation, it is likely that SMEs will be confronted with increased difficultness of obtaining loans for the earlier mentioned reasons. Securitisation could mitigate the reduction of loan supply due to this pro-cyclical behaviour, providing SMEs with liquidity under higher spreads.[179]
Securitisation might also benefit the range of financial products that are available to SMEs. Banks in some countries were able to provide riskier products through the use of securitisation, transferring the credit risk to the investors. An example of these riskier products are participation rights and, another one, subordinated loans. These are riskier because the expected final loss, in the event of a default, is higher. Because of the transfer of risk through securitisation, the supply of these products can be increased.[180]
This is supplemented by the fact that there are possibilities for new (international) competitors joining this segment and taking new products, if there is a secondary market that is functioning and reliable. An example of this are mezzanine instruments which have spread amongst companies located in different member states.[181]
In addition to this, securitisation allows banks to offer SMEs loans with longer maturities. This flows out of the fact that the longer the maturity, the more uncertainty exists concerning the ability of the borrower to repay the loan. It is highly imaginable (especially in the present time) that the credit quality of the SME will deteriorate in its lifetime. This will, in its turn, lead to higher capital costs for

[175] European Commission 2006-2007, p. 16.
[176] European Commission 2006-2007, p. 16.
[177] European Commission 2006-2007, p. 16.
[178] European Commission 2006-2007, p. 16.
[179] European Commission 2006-2007, p. 16.
[180] European Commission 2006-2007, p. 16.
[181] European Commission 2006-2007, p. 17.

the bank. Securitisation again offers a possibility to share this risk with investors.[182]
Furthermore could securitisation be a door-opener for some larger SMEs with better ratings as a securitisation market could enable them to attract alternative liquidity by selling the trade receivables leading to a diminution of working capital and thereby improving trade finance management. [183]

On the other hand, increased SME lending also benefits the securitisation process because bundling the SME loans together in comparable, more diversified, and predictable bundles will be easier when there are more SME loans on the balance sheet.

The OECD acknowledges SME loan securitisation as a tool to alleviate the constraints that the regulatory changes invoked. Thus it can be seen as a tool to benefit SMEs in attracting finance and as well as an improvement of their access to bank finance.[184]

3.3 The overall securitisation market and SME loan securitisation as a niche segment

SME loan securitisation is a relatively new segment of the securitisation market, and can be seen as a niche (i.e. small, distinct and specific) segment of the securitisation market. The whole securitisation market in Europe suffers from the unfavourable economic environment and so does the SME loan securitisation segment.[185]

From around the year 2000, the total market for structured finance in Europe grew, until the economic crisis hit Europe. Even at this time there was a high level of securitisation issuance, however this high level of issuance was mainly the result of the fact that ABS were suitable as collateral in the eyes of the European Central Bank and therefore retained by originators.[186]
Most of the issuances today are still retained by the originator for building (liquidity) buffers and for the purpose of re-financing by central banks. [187]
OECD research points out that in 2008 and 2009 the amount of new issuances on the European market has dropped greatly.[188] It is expected that the issuance (with investors) both in terms of volume and transaction numbers will stay under the pre-crisis levels for a fair amount of time.[189]
According to the European Commission the total share of SME-ABS in 2006 had a 3% market share and is therefore of small importance seen the other classes.[190] In 2007 the share of SME securitisation in Europe was 7% of the total volume of ABS.[191]

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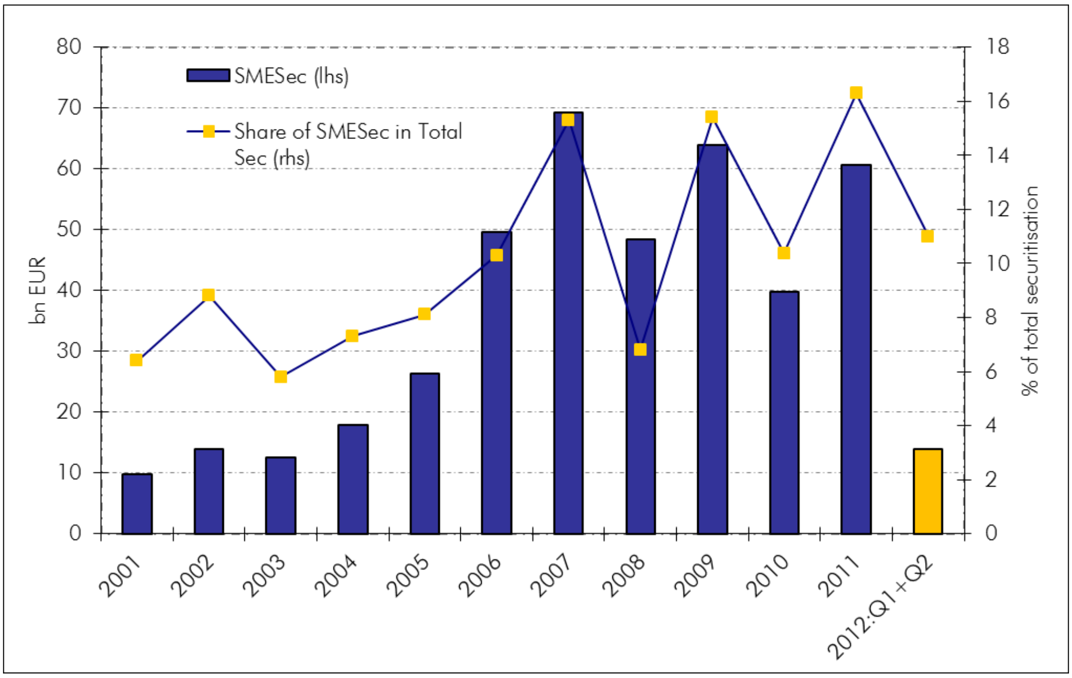
[182] European Commission 2006-2007, p. 16, 17.
[183] European Commission 2006-2007, p. 17.
[184] OECD working party on SMEs and Entrepreneurship 2009, p. 24.
[185] OECD working party on SMEs and Entrepreneurship 2009, p. 24.
[186] Kraemer-Eis et al. 2012 (no. 14), p. 30
[187] Kraemer-Eis et al. 2012 (no. 14), p. 30
[188] OECD working party on SMEs and Entrepreneurship 2009, p. 24.
[189] Kelly & Kraemer-Eis 2011(no. 10), p. 24
[190] European Commission 2006-2007, p. 13.
[191] Rahe 2008, sheet 2.

The SME securitisation transactions have downgraded greatly during the crisis because of four important reasons. The first one being the economic downturn in general and the second one is the fact that rating agencies started using different rating methodologies.[192] The last two reasons are more specific to certain countries; Spain dropped in a serious recession, this is a country that had a sound securitisation market concerning SMEs. The last reason is that some SME securitisation transactions which are non-typical (such as the Mezzanine Collateral Debt Obligations in Germany) suffered significantly, leading to serious downgradings. In 2009 and 2010, the SME securitisation transactions accounted for nearly half of all downgrades by Moody's. [193]
In 2011 not many deals were launched and the resurrection of the SME loan securitisation market has proven to be difficult even though it is likely that the instrument will continue to be an advantage for banks concerning portfolio and risk management as well as for refinancing. It is expected that the structured finance market in Europe will recover at a slow pace.[194]

Figure: Shows on the left hand side the issuance of SMEsec in billions of Euro's. On the right hand side is shown how much the issuance is in percentages of the securitisation total (complete to 2011).



Source: Kraemer-Eis et al. 2012 (no. 16), p. 34

There is room for expansion of the SME loan securitisation segment within Europe. As mentioned before: it is small as an asset class. Secondly, within this asset class, a small amount of assets were actually securitised.[195] In 2004 a study showed that at that time roughly 15% of the banks' assets

[192] Kelly & Kraemer-Eis 2011(no. 10), p. 25.
[193] Kelly & Kraemer-Eis 2011(no. 10), p. 25.
[194] Kraemer-Eis & Lang 2011 (no. 12), p. 31
[195] European Commission 2006-2007, p. 13.

were SME account exposures representing[196], in that time, circa 3,300 billion Euros.[197] At that time the European Commission evaluated, based on the previous assumptions, that 1-2% of the SME loans on balance sheets of the banks, that are suitable for securitisation, were actually securitised.[198] In the RMBS' group the 'securitisation ratio' is much higher. Within this group the percentage was near 10% of the total outstanding volume.[199], indicating the relatively low volume of SME loans that were securitised compared to the volume that was actually suitable for securitisation. [200]

3.3.1. Reasons for the lagging behind of the SME loan segment

The SME loan securitisation segment has not reached full potential on the matter of the size in the total securitisation market and neither as a tool to help SMEs get access to finance.[201] What is the cause for this market segment to lag behind to the rest of the market? Compared to, for example, mortgages; why is it that securitisation in that market segment actually did help people in getting mortgages? The securitisation efforts in this segment achieved an increase in the issuance of mortgage loans and also made them more affordable, even in the case of groups which had low incomes or groups with a bad credit history which would normally be seen as problematic.[202] Summing up all the reasons why the SME loan securitisation market is lagging behind and is hindered in its development would be an impossible mission. The entire market has suffered from the economic environment but for the sake of this thesis the economic element is left out of consideration. From the many reasons some of the most important are due to failures in the market, more precisely being market imperfections and the costs of entering into the market.[203]

3.3.1.1. Market imperfections and failures

Because SMEs are a broad group of enterprises, the loans handed out to them come in many different forms and are very diverse. Hence, a portfolio containing SME loans is more heterogeneous compared to, for instance, a portfolio containing mortgages.[204]

In addition to this, fact is that they are not so homogenous as for example bonds or loans of bigger companies with credit ratings being done by external parties.[205]
The 'SME securitisation final report' provides an illustration of why it is hard to analyse such a portfolio:

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[196] Price Waterhouse Coopers 2004, p. 47.
[197] Legro 2009, p. 29.
[198] European Commission 2006-2007, p. 13.
[199] European Commission 2006, p.49.
[200] European Commission 2006-2007, p. 13.
[201] European Commission 2006-2007, p. 4.
[202] European Commission 2006-2007, p. 4.
[203] European Commission 2006-2007, p. 4.
[204] Legro 2009, p. 35.
[205] European Commission 2006-2007, p. 17.

- There are companies of different sizes which obtain loans. These vary from companies of very small size and which have little to no management structures to very good organized companies of medium size.[206]
- Loans are extended to SMEs from different regions and also industries.
- The various legal forms in which SMEs engage in business.
- Collateral; If there is any collateral, the different types can be problematic as there is much variety in this. [207]
- The 'kind of flavours' of the loans i.e. trade finance, overdrafts, subordinated, senior, guarantees attached, and more.
- Because of the fact that different kinds of loans are granted, the maturity of these loans also varies alongside the schemes of payment. To provide with two examples there is: The amortization of loans which means that principal and interest is paid in periodic payments, and the so called 'bullet structures' in which the principal is paid back in a single distribution in the end.[208]

This great diversity of SME loans is at the base of the problem making it harder to securitise SME loans compared to other assets. This problem is that the portfolio is hard to rate; leading to an information asymmetry between the originator and investors concerning the portfolio quality. The investors will want the information to see the risk they will expose themselves to when investing in these securities. In order to actually invest in them it is important that the investors have the conviction that the quality of the portfolio is good and that there is enough data which is also reliable enough to give a good estimation of the losses that can be expected.[209]
Rating agencies are of use since they are helpful in mitigating this information asymmetry and are thereby boosting the investors' confidence in the investment. These agencies will analyse the corresponding portfolio using both historical data concerning losses and defaults as well as their own data and experience. By comparing these two, the agencies can come to an assessment of the portfolio quality.[210]
The safety margins that are applied by the agencies in the assignment of the ratings depends on the amount and quality of the data or information. If the data is not reliable or is of lesser extent, the higher the margins will be.[211] Problematic is the fact that the loans concern SMEs which are possibly start-up companies or other small companies and thus available historical data concerning financial performance is often of lesser extent and, in addition, there is, especially at this time, much uncertainty about their future.[212]

3.3.1.2. Costs for entering the market
Entering the market implies extra costs, these costs could be reasonable, and worth the expense if an

[206] European Commission 2006-2007, p. 18.
[207] European Commission 2006-2007, p. 18.
[208] European Commission 2006-2007, p. 18.
[209] European Commission 2006-2007, p. 18.
[210] Legro 2009, p. 35.
[211] European Commission 2006-2007, p. 17.
[212] Legro 2009, p. 35.

originator chooses to engage in securitisations more often. These costs also derive from the varied nature of SME loans.[213]

For some players these costs are not a pressing issue, but since lending to SMEs is frequently done by small and/or regional banks and credit institutions, to them it actually can constitute a problem.[214] Therefore a 'level playing field' in the form of a standardised platform could come in handy, granting these regional banks easier access to capital markets through securitisation.[215] In my conclusion I will elaborate my ideas on such a standardised platform, what it should look like and its inner workings.

A second issue is that a database of great extent is a prerequisite for banks, enabling them to securitise this great variety of loans.[216] This leads to high costs entering the market as many smaller banks often do not have such a database, or the IT infrastructure enabling them to engage in a securitisation transaction, available or present. In order to obtain this, costs have to be made.[217] For banks using the IRB-approach (Internal Ratings Based) this is probably less pressing since they already had to improve their database according to Basel II regulation and have SME rating systems present.[218]

The earlier mentioned costs are mostly start-up costs, with these costs come additional costs per securitisation transaction such as costs for using third party services: rating agencies, arranger, legal advice, SPV and SPV management and trustees.[219]

Because of the complexity of some transactions the costs also rise and therefore it is necessary that the portfolios are worth hundreds of millions of Euro's in order to achieve a reasonable level of cost efficiency: a portfolio size that could prove problematic for small banks.[220] However, a survey conducted by the AMTE suggests that there is no decisive result for the question whether the size of the portfolio is insufficient to engage in securitisation transactions. 43% of the originators corroborate this as an issue, while an equal percentage did not acknowledge this as a pressing obstacle for securitisation.[221]

In different countries most of the SME lending is depending on these small (regional) banks, but to these banks the obstacles for entering the market are relatively high. So the fact that much of the lending to SMEs is done by small regional banks is problematic.[222] For them the transfer of risk to investors could prove useful.[223]

The fact that the portfolios have to represent a value of several hundred millions of euros to be cost efficient, is also important for the height of the risk premiums demanded by the investors. The slogan: the bigger the better is in this case the truth since bigger portfolios imply better

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[213] European Commission 2006-2007, p. 18.
[214] European Commission 2006-2007, p. 4.
[215] Legro 2009, p. 35.
[216] European Commission 2006-2007, p. 18.
[217] Legro 2009, p. 36.
[218] European Commission 2006-2007, p. 18.
[219] European Commission 2006-2007, p. 18.
[220] European Commission 2006-2007, p. 18.
[221] Euro Debt Market Association 2006, p. 17
[222] Legro 2009, p. 36
[223] European Commission 2006-2007, p. 19.

diversification. The height is not only dependent on the portfolio size, but also on the structure robustness. When parties are more familiar with the structures at the base of the transactions, the costs and time necessary to analyse the portfolio quality are reduced. Thus, in this respect it is also advisable to have a standardised platform.[224]

The AMTE supports the view that costs are a great barrier for SME loan securitisation. Important to note concerning their survey however is the fact that it is a partial exercise, because some countries such as Spain and France (which are significant players), did not answer or participate. Participation from German banks was also limited.[225]
According to their empirical survey it even looks like the costs are the obstacle that is most important. From all the banks that answered, 57% found that securitising SME-loans is too costly, against which 16% did not share the same opinion concerning the costs and stated that the costs are not much of a problem. [226] The survey showed furthermore that some originators were held back by the costs in using securitisation techniques as well as to increase lending to SMEs. A vast majority of banks indicated that they would lend more in numbers and volume to SMEs if there would be a more cost-efficient possibility of risk transfer.
According to the survey, originators ascribe a lot of advantages to securitisation, of which the most important one seems to be SME risk management.[227]

Conclusively can be said that the survey shows that for some banks it is simply too expensive to securitise SME loans and thereby prevents them in engaging in securitisation transactions and increase their SME lending.[228] The costs associated with securitisation could thus be an important reason why many regional or smaller banks do not engage in the securitisation of SME loans. Notwithstanding the many advantages of the risk transfer, the sole portfolio size does not allow risk management to grow more active in order to increase the capacity to lend.[229]

The incentives for smaller banks have pretty much been covered. However, what are the reasons not to securitise for bigger banks which are able to afford it? In my opinion, there are several reasons.

The first is that banks mainly retained their securitisations last years. Originators mostly retain their new issuances (so they are not available to the investors) in order to benefit from the repurchase facility that the ECB provides. Originators can use ABS (and other assets) for collateral in order to attract funding from the ECB.[230] The main motive is thus the usage as collateral, and liquidity buffer creation.[231]

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[224] European Commission 2006-2007, p. 19.
[225] Euro Debt Market Association 2006, p. 17.
[226] Euro Debt Market Association 2006, p. 17.
[227] Euro Debt Market Association 2006, p. 17.
[228] European Commission 2006-2007, p. 19.
[229] European Commission 2006-2007, p. 19.
[230] Kraemer-Eis et al. 2010 (no. 007), p. 6.
[231] Kraemer-Eis et al. 2013 (no. 18), p. 4.

In addition, to get a better insight, I asked an investor-relation employee at ABN AMRO bank[232] what caused them not to securitise SME loans (or other ABS) anymore.

During this contact a few things became clear to me: they specifically choose not to engage in another SME Asset Backed Security transaction since it is not attractive to them anymore, same probably goes for many other banks.
An important factor for the unattractiveness has been the change of regulation; Under the regulatory Regime of Basel I it has been very attractive to securitise SME loans (in the light of capital requirements) because the loans could almost be moved in their entirety from the balance sheet of the bank. In that case the Risk-Weighted Assets (RWA) would decline, and as a result less underlying capital was needed to cover it. Under Basel II and now Basel III this has changed dramatically making it many times more difficult to get the assets of the balance sheet, making it much more expensive (e.g. because of article 122a CRD treated in chapter 4).[233]
In addition, regarding the circumstances on the financial markets as well as the troubles in the SME sector, the spreads that investors would demand from the bank for these instruments would be very high. Probably even higher than the banks would be able to fund their selves, meaning unattractiveness as well.
Basel III regulations also state that these kinds of securitisations (SME loans) are not allowed to fall in the regulatory liquidity buffer, and so from this point it is also unattractive to compose these instruments.[234] For a more elaborate effect of regulation I would like to refer to chapter 4.

Another reason for a reduced attractiveness could also be a decrease of the investor base.[235] I also asked the Rabobank (same as ABN AMRO bank, in an informal way, without a survey), what the reason for them was not to securitise these loans, they gave the lack of investor interest as an important reason.[236]

3.4. Why would investors want this securitised product?

First of all, in order to (re)create a noteworthy market for SME loan securities, it is essential that there is sufficient support from the involved parties. In this case those would be the originators (banks), and the investors. As mentioned earlier the motives for originators have probably remained the same (with some post-crisis adaptations), being portfolio and risk management as well as (diversification of sources of) finance.
Investors have their own reasons for investing in this product. It is useful to know who the typical investors are and what their reasons are for investing in these products.

3.4.1. The investors

Important to know is that the potential investors for this distinct class has pretty much been limited to just specialised investors.[237]

[232] I contacted the ABN AMRO bank because they still have an outstanding transaction: SMILE 2007
[233] Kraemer-Eis et al. 2010 (no. 007), p. 6.
[234] With special thanks to Jan-Willem Stokhuyzen from ABN AMRO Investor Relations.
[235] Kraemer-Eis et al. 2010 (no. 007), p. 6.
[236] With special thanks to Carolien van Eggermond of Control Rabobank Group.
[237] OECD working party on SMEs and Entrepreneurship 2009 p.24

In 2006, the total ABS investments in Europe consisted for 80% out of investors from Europe, Asian investors accounted for 5%, and 4% was bought by North-American investors. In 2006 the main investors in these securities were banks, accounting for 47% of all offered European Asset Backed Securities.[238]
A total of 39% of the European ABS were bought by fund managers, insurance- and pension funds.[239]
Based on this, the investor base will exist mainly out of specialised investors from Europe. With respect to this, a standardised platform for all European countries might be desirable in order to create a 'level playing field'.
There are several reasons why I think there will be, at least in theory, sufficient demand from investors for SME loan securities once a noteworthy market has re-emerged.

3.4.2. The rationale to invest in ABS as a broader group

First, why would anyone invest in ABS anyway? A very apparent reason would be diversification of their investment portfolio: it gives the possibility to investors to access an extensive asset range. Diversification by adding ABS in the portfolio decreases the risk in it.[240] Secondly, there are all sorts of risk categories thinkable, so for every risk preference there are investment opportunities.[241]
In addition could be said that yields provided by ABS have been better compared to several other assets in the past[242] (before the crisis), and could possibly regain this attribute when times get better. In addition to this; the ABS returns used to be relatively higher compared to non-securitisation investments with similar ratings. Because of this, the yield thresholds were higher for investors.[243]
There are also some advantages that are more specific to the SME ABS sector or SME loan securities. The fact that the interest rates are very low might contribute to more potential investors, as some might want to take more risk in order to get a higher profit. If the possible gain from investing in SME loan securities is higher than the interest rate would be, investors might be willing to take more risk.

3.4.3. The rationale to invest in SME loan securities specifically

There are some arguments that some would classify as "immoral" arguments, such as the wish some local investors feel to support SMEs in their area or country.
Some investors that want to support SMEs would encounter the high costs and risks this carries. Bundling support to SMEs by securitising multiple loans constitutes a good solution to accomplish a decrease in risks and costs. The investor invests in a note of a certain portfolio of which the investors knows the risks to greater extents.[244]
The size of the note (or the volume) would be large enough to mitigate the relative costs, justifying the additional transaction costs that accompany the specific investment.
In addition the note could be both liquid and tradable which means that investment portfolios' can be adapted at proportional costs. Another option is that the note is sold when the credit quality is

[238] European Commission 2006-2007, p. 8, 9.
[239] European Commission 2006-2007, p. 9.
[240] European Commission 2006-2007, p. 11.
[241] European Commission 2006-2007, p. 12.
[242] European Commission 2006-2007, p. 12.
[243] Basel Committee on Banking Supervision 2011, p. 13.
[244] European Commission 2006-2007, p. 11.

expected to decline. [245]
Furthermore, securities which are SME asset backed have an advantage for investors since the correlation between them and some other asset classes, in different sections of the financial markets, that are seen as more traditional, is limited.[246] This means there is less interdependence between the securities that are SME asset backed and other asset classes. This is advantageous for investors in this asset class since it enables them to, as the final report on SME securitisation states, "diversify away from large corporate exposure".[247]

3.5.Winding up

In theory SME securitisation seems to be very beneficial. On the other hand, in practice, it does not seem to be used very much. In this chapter the background of the market has been discussed, and also some problems that may arise. Of great importance are market fundamentals and their development as well as an increase in the confidence by investors to help SME securitisation (back) on its feet, but maybe even more important are regulations governing these transactions. Both the indirect as the direct effects are of importance.[248] Provided all this information, the next chapter will be discussing regulatory initiatives with the focus on the Basel III accord, Solvency II, AIFMD and UCITS IV.
The effects of these regulatory initiatives will be discussed and, if possible I will pose some recommendations in the conclusion. As concerning the non-regulatory issues, important is that the newer and smaller asset classes are, the less investors will be familiar with it and thus be more sceptical towards it. This means that, when issuance is small in numbers and volume, investors will not be too keen on them.[249] On the other side, older, more matured and bigger asset classes, will grow to be better-known and thereby investors will grow to be more familiar with them. When this happens, the willingness of investors to invest in the asset class will then exist at risk premiums which are lower than if the investor is not so familiar. The premiums will be lower since they will no longer be driven up because of insufficient liquidity or safety margins that come with the unfamiliarity with the asset class.[250]
If the amount of issuances and also the volumes of issuance of SME loan securities are increased, this will lead to a decrease of transaction costs,[251] making extensive issuing a goal in itself to promote SME loan securitisation.

In theory there could be incentives for originators to engage in, and for investors to invest in, SME securities or ABS as a whole, however, fact remains that investor demand is low.[252]
It is of great importance that investors regain their trust in the transaction quality. This is, as mentioned above, a requirement that draws investors back to investing in this asset class and fulfil an important necessity: a liquid secondary market. This will lead to advantages that are channelled to

[245] European Commission 2006-2007, p. 12.
[246] European Commission 2006-2007, p. 11.
[247] European Commission 2006-2007, p. 11.
[248] Kraemer-Eis & Lang 2011 (no. 12), p. 31
[249] European Commission 2006-2007, p. 12.
[250] European Commission 2006-2007, p. 12.
[251] Euro Debt Market Association 2006, p. 28, 29.
[252] Basel Committee on Banking Supervision 2011, p.7.

the borrowers, which means that the bank loan supply would increase. Besides this, also the product diversity will increase.[253]
A necessity for originators is economic feasibility. If the transactions are not economically feasible, there is no point for originators to engage in them.
For both investors and originators, an essential condition to get involved in these transactions is a regulatory framework which provides stability, certainty and clarity. Improved transparency is another requisite and would greatly contribute to a revival of ABS.[254]

[253] European Commission 2006-2007, p. 12.
[254] Kelly & Kraemer-Eis 2011 (no. 10), p. 27

4. Analysing the regulatory framework

The goal of this chapter is to provide a better insight in what kind of regulations are affecting the (demand for and supply of) securitised products, and, where possible, more specifically for SME loan securities and SME lending itself. It is important to realise that these transactions, and especially the involved parties, are governed by many different rules. In addition there are many regulations or rules that have effect on demand for or supply of securities. In this chapter it is assumed that on the level of loan transfer there are no major issues. The main goal is to look at more overarching regulations.

4.1. The legal framework

Important to know is that the drafted legal framework that is used in this thesis is not intended as to be complete. Many different regulations and rules affect the process of securitisation and potential investors, and therefore it is difficult to draft a complete framework. However some interesting and important regulatory initiatives will be discussed.

Table showing important regulatory initiatives that will significantly affect the market and its components.[255] *The initiatives have been numbered for the overview further in this chapter. The main focus is the impact on originators and investors. Product structuring is important as well but their consequences will not be treated.*

Originators are affected by:	**Investors are affected by:**	**The product or product structuring is affected by:**
1. Basel III regulation and the corresponding Capital Requirement Directive (CRD)	1. Basel III regulation and the corresponding Capital Requirement Directive (CRD)	1. Basel III regulation and the corresponding Capital Requirement Directive (CRD)
	2. Alternative Investment Fund Managers Directive (AIFMD)	5. European Market Infrastructure Regulation (EMIR)
	3. Solvency II	6. (Future) Regulation concerning rating agencies (CRA)
	4. Undertakings For Collective Investment In Transferrable Securities (UCITS IV)	

4.1.1. Basel III and CRDs

After the Basel I and Basel II accords, as of 2013 the third accord Basel III is supposed to take force (spread over multiple years).[256] The Basel Committee created these reforms in order to strengthen and improve global liquidity- and capital rules. These reforms are mainly based on lessons learned from the financial crisis. The goal of these improvements is to make the banking sector more resilient to shocks that are a result of economic and financial distress from any source, consequently

[255] This division has been made, but not investigated or explained, in: Kraemer-Eis & Lang 2011 (no. 12), p. 31.
[256] Basel Committee on Banking Supervision 2010 (revision 2011), p.27ff.

decreasing the financial sectors' spill over risks to the economy, hence improving financial stability.[257] In addition, the aim is to improve disclosures by banks and their transparency as well as to improve governance and risk management.[258]
The committee acknowledges that for economic growth to be sustainable, a resilient, stable and strong banking system is a must. Banks are providing necessary services to governments, SMEs, bigger corporate firms, and consumers which are dependent on the banking business on both nationally and internationally.[259]

CRD
CRD IV is the instruments used for implementing Basel III in the EU,[260] and means an enhancement to Directive 2006/48/EC and Directive 2006/49/EC.[261] The potential adaptations are in a close line with the improvements for the framework provided by the Basel II accord and are also closely aligned with the introduction of Basel III.[262]

4.1.2. AIFMD[263]
The AIFMD is another initiative that was triggered by the financial crisis in 2008. A first concept of the EU directive was made available in 2009. After intense debate, on the 8th of June in 2011 the directive had been adopted by the European Parliament and the European Counsel. The directive has to be implemented before July 22nd 2013.

Application
The AIFMD is applicable on all managers of any type of fund which does not fall under UCITS (see paragraph 4).[264] So the AIFMD covers funds that operate in alternative sectors such as real estate, private equity and hedge funds, but also funds that operate in more traditional sectors but which are not UCITS registered.[265]
This means that all funds that do not fall under UCITS fall under the scope of the AIFMD, even though the name of the directive might suggest a limited scope of application.[266]
As of 2012 all fund managers which participate on the European market are obliged to apply for a permit, either under the AIFMD or under the UCITS IV directive.[267]

4.1.3. Solvency II[268]
The Solvency II directive is the successor of the Solvency I directive. Solvency II has been adopted by the European Parliament in April 2009 and by the European Council in May 2009. The date of implementation is rather unsure because of delays the project has encountered.

The directive will replace Solvency I with adapted rules concerning valuation principles, capital

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[257] Basel Committee on Banking Supervision 2010 (revision 2011), p.1.
[258] Basel Committee on Banking Supervision 2010 (revision 2011), p.1.
[259] Basel Committee on Banking Supervision 2010 (revision 2011), p.1.
[260] Hilbers interviewed by van den Nieuwenhuijzen 2012, p. 5.
[261] European Parliament, Director-General for internal policies 2011, p.71.
[262] European Parliament, Director-General for internal policies 2011, p.71.
[263] Directive 2011/61/EU.
[264] Smits 2012, p. 200.
[265] Kinsch et al. 2010, p. 1.
[266] Smits 2012, p. 200.
[267] Wotte & Rietdijk 2011, p. 130.
[268] Directive 2009/138/EC.

requirements and risk management in order promote better risk and solvency management.[269] The goal and idea are very similar to that of the Basel II accord. The first is to harmonise the international supervision, in view of creating a 'level playing field' and a 'true single market' across Europe. The second goal is to protect creditors (such as policyholders and savings accounts) in order to prevent systemic risks. [270]
The Solvency II directive constitutes a profound revision and adaptation of earlier European directives concerning (re)insurance companies.[271] It is probably the most elaborate regulatory initiative ever created for the insurance business in Europe and is considered to be revolutionary by some.[272]

Application
Solvency II applicability will be based on the (re)insurers gross premium income (GPI). If the GPI is more than 5 million Euros the Directive is applicable. If the gross technical provisions (GTP) are higher than 25 million Euros the directive is also applicable.[273] In the case insurers do not reach these thresholds now, but are anticipated to do so in five years, the Directive is applicable.
Small insurers (GPI under 5 million Euros and GTP under 25 million Euros) which are not part of a bigger group, offer no credit, liability or surety insurance, and do not reinsure, do not fall under the scope of Solvency II. Same goes for pension funds and some others. Small insurers are however allowed to "opt in" under the scope. [274]

4.1.4. UCITS IV[275]

Even though movements towards UCITS V and UCITS VI have been made by the European Commission, these will probably not enter into force before the third quarter of 2014, and more probable in 2015. Therefore I will analyse UCITS IV rather than these future directives.

The UCITS IV directive has been adopted by the European parliament in 2009.[276] All member states had to implement the directive in domestic laws in 2011; however some countries experienced delays in this process. The revision of the earlier UCITS directive has greatly augmented the harmonisation process of the European Regime concerning investment funds.[277]
A fund that has been set up according to the UCITS Directive is called a UCITS fund.[278] Even outside the EU the UCITS brand is known and registered UCITS funds can be found.[279]

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[269] De Nederlandsche Bank N.V. 2010, p. 4.
[270] Doff & Bilderbeek 2007, p. 29.
[271] De Nederlandsche Bank N.V. 2010, p. 4.
[272]Doff & Bilderbeek 2007, p. 28.
[273] De Nederlandsche Bank N.V. 2010, p. 4.
[274] De Nederlandsche Bank N.V. 2010, p. 4.
[275] Directive 2009/65/EC.
[276] Ferguson et al. 2009, p. 1.
[277] Ferguson et al. 2009, p. 1.
[278] European Fund and Asset Management Association 2009, p. 14.
[279] Anderberg 2009, p. 19

Households across Europe use them and not only European inflow has been attracted to them, but also inflows from investors outside Europe. [280]

Article 1 of the directive gives that UCITS is an undertaking with the sole object of collective investment in transferable securities or in other liquid financial assets, capital raised from the public and which operate on the principle of risk-spreading;[281] and
with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.[282]

Deciding whether your fund should be an AIF or a UCITS fund depends on different circumstances. A decisive factor in choosing could be the investment strategy which may not be in line with the investment restrictions posed by the UCITS rules.[283]

UCITS funds are by far the most important players on the European market for investment firms. [284]

4.2. How does this reflect on the involved parties in securitisation transactions?

4.2.1. Basel III and the Capital Requirement Directives

Under Basel III originators are incentivised to engage in securitisation (of SME loans) to lesser extent, Basel III will also have consequences on lending to SMEs. One of the reasons to engage in securitisation to lesser extent is that under Basel III and the CRD's II[285], III[286] and IV, capital requirements could become as much as ten times higher as they are now.[287] I will try to summarize some of the most important (expected) effects of the legislative initiatives.

<u>Lending</u>
First of all, the introduction of CRD IV and Basel III will undoubtedly lead to banks being more risk averse. This taken in consideration, it will thereby definitely increase the costs of finance and impose higher collateral requirements on SMEs looking for bank finance. This effect will probably not be limited to just SMEs; virtually any average rated business will encounter this problem. A reduction of the credit provision from banks to SMEs is thus expected at implementation.[288]

Secondly, under Basel II, a minimum of 8% of own capital was required to cover risk-weighted assets. There is however a compromise concerning SMEs, the "SME compromise", allowing the division of

[280] European Fund and Asset Management Association 2009, p. 14
[281] Directive 2009/65/EC, article 1 sub a.
[282] Directive 2009/65/EC, article 1 sub b.
[283] Campion-Smith et al. 2012, p. 11.
[284] Slange & Verwilst 2008, p.332 .
[285] Directive 2009/111/EC, Directive 2009/27/EC and Directive 2009/83/EC.
[286] Directive 2010/76/EU.
[287] Härle et al. 2010, p.10.
[288] Campi 2012, p.1.

some of these loans in the "retail portfolio". Requisite is that the credit volume to a single borrower remains below € 1.000.000, which is a requirement met by most of the borrowings to SMEs. The risk weighting applicable to this portfolio is 75%.[289]
Hence, 6% (75% of 8%) of own capital is required to back loans to these SMEs. This will increase to nearly 8% (75% of 10,5%)under Basel III because there will be an all-around raise of the ratio concerning minimum capital to 10,5% and a risk weighting adjustment which could reduce this percentage is not to be included.[290]
This equates to a 100% risk weighting under the present regulation.
Loans to SMEs were definitely not at the base of the crisis, yet they are subjected to this adverse adaptation which is debatable especially when looking at, for instance, the risk weighting of government bonds, or other risk weightings for that matter. [291]

Furthermore, along with Basel III comes a risk weighting increase for securitisations and trading book positions. Assumable is that the higher capital requirements will lead to a disposal of securitisations or trading book positions (as well as a decrease of investments to securitisation), thereby invoking a release of regulatory risk capital which can be allocated for loans to SMEs. [292] This might look like a positive development for the financing of SMEs, certainly since positions which are considered risky will be covered by more capital and as corporate- and private loan risk weightings remain unimpaired.[293]
However, the situation on the capital markets is still unstable. This is especially the case on the securitisation market, therefore question remains if the parties will actually be able to get rid of these transactions once Basel III enters into force and therewith the increased risk weightings.[294]

Securitisation
New rules included in Basel III will have the potential to influence securitisation by changing bank incentives for both holding securitisation assets as well as for the securitisation of loans itself. The most influential reforms concerning securitisation are most likely the ones mentioned below.[295]

Firstly, in CRD III (amended to implement Basel II), re-securitisations in the trading- and banking books have been bound to capital requirements which are higher and so have securitisation positions which are considered complex.[296] Also capital charges concerning market risk were introduced. The expected result of this combined, was an amplification of the capital, being three times higher than before.[297]
Under Basel III, the applicable risk weights for re-securitisations have been increased profoundly especially when compared to other (securitisation) exposures. This is the case for both the IRB

[289] Angelkort & Stuwe 2011, p. 12.
[290] Angelkort & Stuwe 2011, p. 12, 13.
[291] Angelkort & Stuwe 2011, p. 13.
[292] Angelkort & Stuwe 2011, p. 13.
[293] Angelkort & Stuwe 2011, p. 13.
[294] Angelkort & Stuwe 2011, p. 13.
[295] Basel Committee on Banking Supervision 2011, p 24.
[296] Auer & von Pfoestl 2011, p.8
[297] Härle et al. 2010, p.11.

approaches (internal ratings based), as well as for the standardised approach. The results are higher capital requirements.[298] The measures concerning re-securitisations were in my opinion necessary to decrease the risk that is implied with re-securitisations.

Secondly, there has been too little adequate due diligence from the investor side. In order to counter this, as well as to prevent the investors from exclusive external credit rating reliability, banks have to live up to certain operational criteria which are needed for using the Basel II risk weights concerning securitisation.[299] When banks do not measure up to these requirements for given exposures (to securitisation), this will lead for the exposure to be risk weighted with a percentage of 1,250%. This is the same result as if it was a deduction from capital.[300]

Where the underlying collateral has not been subjected to due diligence the 1,250% risk weighting is applied, and also for exposures which are unrated or of another specified rating.[301] These securities with low rating used to be deducted (there was a choice, deduction often was the best one) from capital under Basel II (with a ratio of tier 1 and tier 2 of 50:50).[302] The new risk weighting, combined with an increased capital ratio (described under “lending” of this chapter), leads to profoundly increased capital requirements possible ranging from approximately 40% up to 100% for deduction items.[303] Remarkably this could even lead to circumstances in which the Tier 1 capital that is required outgrows the nominal securitisation value.[304]

Basel III also heightens the capital requirements for exposures coming from CCR (or Counterparty Credit Risk) which can arise from activities concerning securities financing, transactions with a repurchase character (repo-style), and derivatives. [305]

In addition, the initial margining and collateral management are subject to strengthened standards, and the capital requirements for exposures concerning OTC derivatives are higher. [306]

As for the CRDs, CRD II initiated a higher level of accurateness as well as due diligence for both investors and originators in the securitisation markets.[307] In CRD III (correspondent with Basel II) normal securitisation has been subjected to a tightening of the requirements concerning disclosure of the securitisation exposures, enhancing the transparency on the market.[308]Which in my opinion is a good thing, as increasing transparency is of uttermost importance.

These rules mainly concerned capital requirements as well as some transparency changes. However there are also effects deriving from provisions concerning liquidity ratios.

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[298] Basel Committee on Banking Supervision 2011, p 24.
[299] Basel Committee on Banking Supervision 2011, p 24.
[300] Basel Committee on Banking Supervision 2011, p 24.
[301] Australian Prudential Regulation Authority 2012, p. 21.
[302] Härle et al. 2010, p.11.
[303] Härle et al. 2010, p.11.
[304] Härle et al. 2010, p.11.
[305] Auer et al. 2011, p.5.
[306] Auer & von Pfoestl 2011, p.8
[307] European Parliament, Director-General for internal policies 2011, p.78.
[308] European Parliament, Director-General for internal policies 2011, p.78.

In this context, a distinction has to be made between the two possible ratios. The first one is the “liquidity coverage ratio”, of which the goal is to make sure that banks have adequate levels of assets of high quality and which are unencumbered. When needed (under a scenario where there is “acute liquidity stress”) it must be possible to convert these assets into cash to satisfy the need for liquidity (for 30 days) .[309]
The second ratio is the so called “net stable funding ratio”: trying to promote stable funding of banks’ activities and assets for the medium term as well as longer term.[310]
The potential effect for securitisation lies in the fact that they are excluded from the buffer in the liquidity coverage ratio, which only concerns liquid assets of high quality. This is because securitisations are seen as illiquid.[311] I call it a potential effect as the ratios will be subjected to periods in which the effects will be observed, and possibly have the calibration changed before entering in full force.[312]

<u>Skin in the game</u>
Very important in the light of incentives in securitisation is the “skin in the game” rule.
Ever since art. 122a of CRD II has been passed(which has been anticipating a piece Basel III), before buying securities, investors have to make sure that the originator has “skin in the game”. This rule means that originators have to hold a minimum of 5% of the created securitisations at any given moment before investors (not being the originator, sponsor or original lender) are allowed to invest in the securitisation.[313] Losses on the originators’ securitised exposures do not necessarily affect the 5% which is calculated by using the nominal value at the time of origination.[314]

There is a double effect: originating banks need to hold 5% of their portfolio (implying higher capital costs), and other banks (or other investors subjected to the “skin in the game” rule) cannot invest in the securities unless the originator holds an interest of at least 5%.

There are four different options for the originator to retain 5% under article 122a.

1. The so called “vertical slice” which means a minimum retention of 5% of every tranche its nominal value. It can also be achieved by retention of the same percentage of the credit risk of the securitised exposures.[315]

2. “Originators interest”: This mean that the originator’s interest in the exposures is retained, again with a minimum of 5% of the nominal exposure value. [316] Requirement however is that the securitisation either is revolving or has “revolving exposures”.[317]

[309] Basel Committee on Banking Supervision 2011, p 24.
[310] Basel Committee on Banking Supervision 2011, p 24.
[311] Basel Committee on Banking Supervision 2011, p 25.
[312] Basel Committee on Banking Supervision 2011, p 25.
[313] Härle et al. 2010, p.11.
[314] Committee of European Banking Supervisors 2010, p. 21.
[315] Committee of European Banking Supervisors 2010, p. 24.
[316] Cadwalader, Wickersham & Taft LLP 2010, p. 8.
[317] Committee of European Banking Supervisors 2010, p. 25.

3. This option consists of retaining a random selection of exposures. This option is usable in both traditional securitisation and synthetic securitisation. The retained exposures however, may not be subject of synthetic securitisation. This means that the sponsor, original lender or originator is not allowed to have the retained part protected against its credit risk. It is also called retaining “on-balance sheet”.[318] Required is thus that the exposures would be securitised if they were not kept on the balance sheet and, additionally, the total amount of retained plus securitised exposures must be higher than 100.[319]

4. The “first loss piece” retention means that the retention is entirely in the tranche that bears the first losses and, when needed, also parts of tranches with the same or a worse risk profile than the ones sold/transferred to the investors. So this could mean they are senior to the first loss tranche, but junior to the tranches sold.[320]
   The tranche bearing the first loss can consist of several different exposures, e.g. a deferred purchase price element, subordinated note, et cetera. [321]

In situations 1 and 4, the originator, original lender or sponsor retain a part of the issued tranches. In situations 2 and 3 the retention consists of a part of the exposed pool which is(intended to be) included with the securitisation.[322]

This is where we see a part of the possible impact; for some options this could mean an increase to the capital requirements of up to 500% (at a first loss piece) for the originating bank. As where other options have an estimated impact for the capital requirements which could very well be up to 50% (vertical slice).[323]

4.2.2. AIFMD and UCITS IV

Noteworthy is that the AIFMD is just a framework (level 1). This framework requires the Commission to come up with certain detailed rules concerning many different topics. Of these required detailed rules, many have been adopted in the Level 2 Regulation being a sort of delegated regulation.[324] AIFM investment powers are overall not restricted by the AIFMD. However in the Level 2 regulation some essential requirements concerning the processes for risk management and investments for AIFs can be found.[325] I will use the abbreviation AIFMD for both level 2 as well as the main AIFMD.

Risk retention

In the AIFMD the “skin in the game” rule is also adopted. Article 17 of Directive 2011/61/EU has been extended in the level 2 regulation with more requirements in section 5.[326] Article 51 of the level 2 Regulation states that the originator, sponsor or original lender has to retain a net economic interest

[318] Committee of European Banking Supervisors 2010, p. 25.
[319] Cadwalader, Wickersham & Taft LLP 2010, p. 8.
[320] Committee of European Banking Supervisors 2010, p. 26.
[321] Committee of European Banking Supervisors 2010, p. 26.
[322] Cadwalader, Wickersham & Taft LLP 2010, p. 8, 9.
[323] Härle et al. 2010, p.11.
[324] Robson & Hilditch 2013, p. 1.
[325] Ng 2013, p. 8.
[326] Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012.

of not less than 5%, for the AIF(or the AIFM for AIFs), to be allowed to invest in the securities.[327] Article 51 of the Level 2 Regulation gives five options in which the risk retention can be accomplished being: a vertical slice (sub a), originator's share (sub b), random selection (sub c), first loss tranche (sub d), or first loss exposure (sub e).
In article 51 are also some circumstances mentioned when these rules do not apply.

In addition, article 52 and 53 of the level 2 Regulation provide certain qualitative requirements concerning AIFMs exposed to securitisations and concerning sponsors and originators. Amongst others, the AIFM has to make sure that credits granted by sponsors and originators, have to be "based on sound and well-defined criteria and clearly establish the process for approving, amending, renewing and re-financing loans to exposures to be securitised as they apply to exposures they hold".[328]

Also there is an on-going duty to monitor the securitisation for the AIFM, "in order to have a comprehensive and thorough understanding of the securitisation investment and its underlying exposure".[329] This has to be done both before and after the investment.[330]

The requirements are very much alike those in the CRD II (art. 122a)for credit institutions and for EU (re)insurance undertakings in Solvency II which yet has to be implemented. CRD IV art. 122a will also apply to EU investment firms.[331] The rule under the AIFMD has to be interpreted in a similar way as art. 122a of the CRD as well as it should be explained consistently with the Guidelines that CEBS (Committee of European Banking Supervisors) issued.[332]
So it seems that through these measures a sort of "level playing field" will be created. However there are still differences in some areas which I will not treat.[333]

These measures of the AIFMD could mean a (temporary) decrease in non-EU managers investing within the EU. For some, it is possible that the burden of complying with the AIFMD is too onerous compared to the interest they have within the EU. In combination with a possible decrease of EU managers, this could mean that in the future, the amount of players will be significantly less. This will possibly decrease the competition. On the other hand there will probably be players trying to use this for their benefit.[334] The expectation is that the AIFMD will affect many AIF's and their managers. A possible result of the implementation of the directive could be less growth of the sector, a limitation on the options to pursue a diversified investment policy for managers and investors, and a decrease in supply to investors.[335]

[327] Directive 2011/61/EU.
[328] Article 52 of the level 2 regulation.
[329] Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012
[330] Ng & Thind 2013, p. 1.
[331] Ng & Thind 2013, p. 2.
[332] Ng & Thind 2013, p. 2.
[333] Ng & Thind 2013, p. 2.
[334] Opp et al. 2012, p. 26.
[335] Wotte & Rietdijk 2011, p. 135.

As for UCITS managers, the same requirements as mentioned above will be adapted. This will be based on a level 2 regulation for the UCITS Directive.[336] UCITS includes some rules concerning portfolio diversification. The goal is to minimize or reduce large exposures to single issuers.
UCITS are not allowed to exceed 5% in investing its assets in instruments on money markets or in transferable securities, if on and the same body issued these.[337]
Exposure to counterparties in OTC derivative transactions is also capped at 5% of its assets, and 10% if a bank is the counterparty.
Furthermore, only under exceptional circumstances UCITS may borrow securities, funds or grant loans. The main rule is that this is not allowed. For the cases it is allowed, there is a cap of 10% of the funds' managed assets.[338]

4.2.3. Solvency II

It is expected that the securitisation market specifically will be hit hard by the introduction of Solvency II. According to an estimation by Fitch Ratings, somewhere near and about 20% of all issuances placed with insurers/insurance companies. [339] If these investments were to be profoundly reallocated, an effect could be that the pricing would be higher and the recovery of the market could be delayed. An increase in the capital charges would very likely constitute such a change in asset allocation away from securitised products[340], and consequently, also away from SME loan securities. Even though solvency II has not yet entered into force, the exposures to securitisation by the insurance industry already have been decreasing. According to Standard & Poor's structured finance research, in which 2007 was compared to 2011, there has been a slight drop in the allocation (to securitisation) of (fixed-income) assets by insurance companies from 7% to 6%. In addition, the allocation to covered bonds in 2011 was more than twice as much as in 2007, growing to 10%.[341] Standard and Poor's believes that this reallocation will be a lasting trend,[342] especially with the introduction of Solvency II.

High capital charges for securitisation.

The required amount of capital that insurers need to hold for assets depends on the mark-to-market loss which is expected when the conditions are unfavourable. This is the SCR: Solvency Capital Requirement. [343]This loss is dependent on the risks the assets bear and the nature of it. The risks are categorized into different modules by legislation. An example: securitisations, covered bonds and corporate bonds are categorised in the module "spread risk". This is because their value on the market is heavily dependent on the credit spread volatility on the secondary market.[344]

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[336] Ng & Thind 2013, p. 1.
[337] European Commission 2010, p. 56.
[338] European Commission 2010, p. 56.
[339] Ramadurai et al. 2012, p.1.
[340] Ramadurai et al. 2012, p.1.
[341] Boyce & South 2012, p.7.
[342] Boyce & South 2012, p.2.
[343] Boyce & South 2012, p.3.
[344] Boyce & South 2012, p.3.

Under Solvency II, insurance companies will be able to choose between two types of formula's to calculate how much capital should be retained for protecting the policy holders. The first option is a standard formula (or standardised approach), which is the same for every insurer no matter in which country in the EU they are established.[345] This will mainly be used by smaller insurance companies. Under this model, the capital charges applicable for securitised assets are very high; or, as the Fitch Special Report on Solvency II and securitisation says, "punitive when compared to those for covered bonds and corporate bonds."[346] As a result, standard formula users will move away from securitised assets, into classes which are more attractive (e.g. corporate bonds with a short duration, and government bonds). [347] Proposed capital charges for securities rated AAA, are 7% per duration year.[348]

The second option is using an internal model, which will be created and tuned for the specific risks that an insurer is exposed to or takes. For obvious reasons, the second model will take more awareness and time to determine the level of solvability that is required. The disclosed information concerning risks will also have to be much more extensive and detailed.[349] By using internal models the impact of Solvency II is potentially reduced, and leads to securitisations being treated more favourably. An estimation was made by Fitch on how high the capital charges would be when using internal models, the result was that for some, the charges could be as low as 10% of what would be required under the standard formula. However, question remains in practice on how much internal models may deviate, meaning that such estimates may be exaggerated. [350]
However, even though the internal model could mean a significant advantage over the standard formula, fact remains that many small insurers cannot use this for their benefit. Internal models are therefore more likely to be used by insurers which are larger and/or more sophisticated.[351]
For some insurance companies it might be difficult or impossible to meet the criteria that internal models have to live up to. One of the most important of these criteria which some insurers will not be able to live up to is the "use test", which means that the model should play an essential role in the system for risk management of the organization and has to be used widely.[352]
The internal model will furthermore not be available to all insurers due to the implied costs for creating, and also maintaining such a model. Another obstacle is the unclearness of which differences to capital charges will be approved by national supervisors under this model, it is very well possible that the internal model will not be so beneficial for the capital charges after all.[353]

This all suggests that after the implementation of Solvency II, the investor base (in the insurance sector) for securitisation products consists merely out of very sophisticated insurers which can bear the costs and have created a model which is approved by regulators. However, this will be very

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[345] Heuvelink & Lobregt 2011, p. 1.
[346] Ramadurai et al. 2012, p.1.
[347] Ramadurai et al. 2012, p.1.
[348] Association for Financial Markets in Europe 2012, p. 1.
[349] Heuvelink & Lobregt 2011, p. 1.
[350] Ramadurai et al. 2012, p.1.
[351] Ramadurai et al. 2012, p.1.
[352] Boyce & South 2012, p.8.
[353] Boyce & South 2012, p.8.

dependent on the deviation allowed from the standard formula concerning the capital charges.[354] Hence, the standard formula will mean a potential "death-blow" to the securitisation investments from the insurance sector, which used to account for over 10% of the securitisation investments total, and the internal model has yet to prove itself to be more favourable.[355]

The capital returns will be lower

The SCR for securitisation is lower than that of re-securitisation however, the SCR of covered bonds is still much lower than that of securitisations.[356] So the prospects for securitisation under Solvency II and the capital charges do not seem very bright. However, if insurance companies are able to achieve a satisfactory good return on capital in comparison to other investments (e.g. covered bonds etc.), the holding of securitisations could still be useful.[357]

Covered bonds spreads, same as securitisation spreads, have declined in 2012, and may continue to do so. Covered bonds however, are preferred because of the capital charge. Investing in covered bonds generates significant higher returns on SCR compared to securitisations because of the difference in capital charges.[358]

To illustrate this, top-rated securitisations with an up to five year-duration, have a capital charge ten times higher than that of equally rated covered bonds. Conclusions could be drawn from the fact that since 2009, nearly all placed securitisation tranches in Europe, have such duration, being maximal five years.[359] However, according to some, the main focus will turn to the risk rather than to the expected returns. [360]

The expected result of this, according to Standard and Poor's research, is that the trend of reducing investments in securitisation will continue as insurers will allocate their capital to higher return providing assets and thus away from securitisation.[361]

Survey amongst insurance companies and asset managers.

According to a survey conducted by the AFME, which questioned 27 asset managers and insurance companies based in Europe with a combined portfolio of €5 trillion in assets worldwide, the preparedness to invest in securitisation assets will drop drastically because of the proposed Solvency II rules.[362] Even though some might wonder whether the survey is representative, I am of the opinion that an overall insight is given in how involved parties think about the initiative.

One of the most important findings was that the willingness of allocating funds to the securitisation sector would be radically diminished. 33% indicated that all activities in the sector would be stopped

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354 Boyce & South 2012, p.8.
355 Boyce & South 2012, p.2, 8.
356 Boyce & South 2012, p.5.
357 Boyce & South 2012, p.5.
358 Boyce & South 2012, p.5.
359 Boyce & South 2012, p.5.
360 Heuvelink & Lobregt 2011, p. 1, 2.
361 Boyce & South 2012, p.2.
362 Association for Financial Markets in Europe 2012, p. 1.

where 67% stated that the willingness would be reduced significantly.[363]
Of the respondents who stated that Solvency II would induce fund reallocation, 85% stated that minimally half of their funds will be taken away from the securitisation sector. [364]
If the capital charges that are proposed will actually be introduced, 22% of the respondents would never return on the securitisation market. Of the ones who would be prepared to come back, 65% would be doing so after at least one year. Nearly 20% would return after at least three years. [365]
In addition, the proposed capital charges could very well be a big incentive to create internal models, as 56% indicated to do so. Pessimism is however lurking as more than 50% of the respondents think that their regulator would disapprove their developed internal model when the outcomes would differ in a material way from the generated results from the standardised approach.[366]
Noteworthy about Solvency II compared to Basel III is, that Solvency II incentivizes to engage in investments with short maturities as opposed to Basel III which incentivizes banks to engage in longer-maturity investments with more stability.[367]

Taken this in consideration, I think that if the current proposals remains as it is, the effects on securitisation will potentially be enormous. However, the impact could be reduced as the regulation could still be adapted and transitional periods could help reduce a shockwave. In addition, it is possible that the legislation could also be postponed once more and after that, it is very well possible that the sector could even have ten years before having implemented the rules concerning capital adequacy. It is expected that the current trend of reducing securitisation investments will continue, especially when the Solvency II that is to be implemented, is much like the current version.[368]
I believe however, that Solvency II will lead to bigger and more sophisticated insurance companies as it is likely that the legislation will constitute an increase in mergers and acquisitions. This is because insurers will try to improve their financial position, helping them carrying the costs that Solvency II implies.[369] This will allow some of them to use internal models which will potentially mean a more beneficial treatment for securitisation investments. However this has yet to be seen as little is known about the freedom to deviate from the standard formula on which it will very much depend.

[363] Association for Financial Markets in Europe 2012, p. 1.
[364] Association for Financial Markets in Europe 2012, p. 1.
[365] Association for Financial Markets in Europe 2012, p. 1.
[366] Association for Financial Markets in Europe 2012, p. 1.
[367] Zähres 2011, p.1
[368] Boyce & South 2012, p.2, 11.
[369] Heuvelink & Lobregt 2011, p. 1, 2.

Conclusion

In this thesis I have researched many different topics. I started off by investigating what SMEs are and, also important, the many different funding options they have with their own advantages and disadvantages. However, due to market failures a finance gap exists for SMEs, and many are struggling to obtain (sufficient) funding.[370] Many of these market failures are linked to asymmetric information on both the demand side as the supply side. Important in this context is the fact that many SMEs lack track record or collateral.[371]
Also important is that these market failures are likely to be magnified in the current economic environment which is dominated by uncertainty, as lenders are becoming increasingly risk averse. So banks tend to lend even less.[372]
Securitisation and its inner workings have been explained as well as how different structures for different goals are used, treated is the "true sale" in which they do not have to hold capital for the assets' credit risk because the assets are moved of the balance sheet. This structure can provide capital relief and liquidity.[373] Also synthetic securitisation (in which only the risk is transferred)is explained , which is preferable for capital relief and risk management.[374]

Bank loans are hard to obtain for SMEs. Securitisation could contribute to SME lending as it allows banks to transfer credit risk they have on their assets (such as SME loans) to investors through an SPV and simultaneously release capital for providing new loans.[375]
For the SMEs there are obviously many advantages such as the better access to finance because of the less cyclical behaviour of banks, the benefit for the range of financial products available to SMEs, and loans with longer maturities (because the credit risk is transferred).[376]
Furthermore, the market has been described and I have concluded that there is theoretical room for growth as the SME loan securities market is behind compared to the rest of the securitisation market, due to market imperfections and failures. There are theoretical incentives for both originators as investors to engage in securitisation transactions. Unfortunately, investor demand is low[377] and originators are reluctant to securitise.

From the side of originators, market imperfections and failures are at the base of the reason why smaller banks are reluctant to engage in securitisation transaction. [378] Again there is the problem of information asymmetry (this time between originator and investor concerning the portfolio quality), which however is mitigated through rating agencies. However safety margins for securitisation are dependent on the quality and quantity of data on the portfolio, however as it concerns SMEs the safety margins are higher. Another obstacle are costs for entering the market.[379]

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[370]Bank for International Settlements 2012, p. 9.
[371] Bank for International Settlements 2012, p. 9.
[372] Bank for International Settlements 2012, p. 8.
[373] Legro 2009, p .20.
[374] Legro 2009, p. 29.
[375] European Commission 2006-2007, p. 3, 4.
[376] European Commission 2006-2007, p. 3, 4.
[377] Basel Committee on Banking Supervision 2011, p.7.
[378] European Commission 2006-2007, p. 17- 19.
[379] European Commission 2006-2007, p. 17- 19.

For bigger banks which are able to bear the costs, the unpreparedness to securitise also has several reasons. One of the more important reasons is that they retain most of the issuances (so they are not issued to the public) to use them as collateral at the ECB to attract funding.[380]
In addition, regulatory changes have made it more expensive and harder to remove the assets (such as SME loans) from the balance sheet and, furthermore, SME securitisations are no longer usable for their regulatory liquidity buffer. I believe that the fact that securitising SME loans has just become to uneconomic is one of the most important ones.
Furthermore, the demanded spreads by investors will be too high because of the circumstances on the financial markets as well as the problems in the SME sector, which in my opinion also is a real concern to them. Another potential reason could be the diminished investor base.

In the final chapter I used a legal framework to research what regulations have (a negative) effect on the parties in the securitisation process. The regulatory initiatives treated are Basel III (and CRDs), AIFMD (Alternative Investment Fund Managers Directive), Solvency II and UCITS IV (Undertakings for Collective Investments in Transferrable Securities)directive.
I found out that Basel III (and the CRDs) will have three very important effects in this context. First, there will be a negative effect on lending to SMEs, as banks will be more risk averse. This will lead to higher costs of finance, and impose higher collateral requirements on SMEs (while as seen before, many SMEs do not have much collateral). The ultimate result will probably be a decline SME lending.[381]
Furthermore, lending will probably decrease because the required capital to cover for (most of) these loans by banks will rise from 6% to 8% because of an overall increase of the ratio concerning minimum capital, without a risk weighting adjustment.[382] Secondly, there will be an effect to holding securitised assets (so for banks as investors, and because of the "skin in the game" rule also as originators) and thirdly, there will be effects for securitising itself.[383]
Many capital charges have been either increased, or newly added, requiring a lot more capital for covering a lot of risks.
Furthermore, securitisations are excluded from the buffer in the liquidity coverage ratio, because they are seen as illiquid. Meaning that it is for banks more attractive to have liquid assets on their balance sheet, which they can easily dispose of when necessary.[384]
And last, but definitely not least, there is art. 122a of CRD II, the so called "skin in the game" rule which requires originators, original lenders or sponsors to retain 5% of their issuance (through 4 options). The capital they need to hold to cover for this 5% could be very high, making it less interesting to securitise.

Under AIFMD the skin in the game rule is also adopted, meaning that investors cannot invest in securitisation if the retention has not been done. For UCITS the same requirements will be adapted as for the AIFMD. There will probably be a decrease in competition from the funds, as well as less

[380] Kraemer-Eis et al. 2012 (no. 14), p. 30
[381] Campi 2012, p. 1.
[382] Angelkort & Stuwe 2011, p. 12, 13.
[383] Basel Committee on Banking Supervision 2011, p.24.
[384] Basel Committee on Banking Supervision 2011, p.25.

growth.[385] I think the effect these regulations will have, will not be too radical compared to the expected impacts of Basel III and Solvency II. Important however, is that all discussed regulations combined, will have a huge impact, and that UCITS IV and AIFMD could mean a decrease of the investor base.

Solvency II will have a great impact on the (re)insurance business. Reallocation by (re)insurers away from securitisation has already started, and it is expected that this will be a lasting trend.[386]
For retaining capital, insurers can choose between two types of formula to calculate this.[387] The standardised approach will pose very high capital requirements for exposures to securitised assets. Under the internal model the impact of solvency II concerning securitisations could be reduced.[388]
However there is uncertainty of how much deviation is allowed from the standardised approach[389] (if this is little it will be more expensive) and in addition, for many small insurers it is too expensive to use, as well as it is too hard to live up to the requirements.[390]
Furthermore, securitisations provide low returns on Solvency Capital Requirements because of the high capital charge for securitisations.[391] The result of all this is a massive reallocation of capital away from securitisation.[392]
With this summary of the chapters, I believe to have answered the research question *“In what way does the securitisation of SME loans contribute to SME finance and how is this process affected/hampered by legislative initiatives?”*

On the one hand I believe a clear, strong regulatory framework providing increased transparency and better risk management is essential in order to draw the investors back to the SME loan securitisation market. On the other hand, it is this very regulatory framework that will probably mean a decrease in potential investors, and also provides originators with enough incentives not to securitise. Through these regulatory initiatives, I believe a large step has been made towards a “level playing field” for the players. For example, there is the “skin in the game “ rule that will apply to the subjects of these regulations and, another example, is the fact that UCITS will be subjected to the same measures as AIFs, as seen in chapter 4. A possible consequence which I have not elaborated very much on, is the fact that merely complying with these regulations can impose an obligation which is very, if not too onerous for some players.

Proposed platforms
In chapter 3 I mentioned that a standardised platform could prove useful in order to solve some of the problems with SME securitisation. I will try to give my vision on what a standardised platform could look like.

385 Wotte & Rietdijk 2011, p. 135.
386 Boyce & South, 2012, p.2.
387 Heuvelink & Lobregt 2011, p. 1.
388 Ramadurai et al. 2012, p.1.
389 Ramadurai et al. 2012, p.1.
390 Boyce & South 2012, p.8.
391 Boyce & South 2012, p.2.
392 Association for Financial Markets in Europe 2012, p. 1.

One of the most important points of such a standardised platform is that a sort of "brand" of securities is created. A brand with sublime reputation which benefits from great investor confidence. Secondly it is very important that issuance is structural and repeated in order to decrease relative transaction costs and entry costs to the market(as described in chapter 3), this is also achieved because a standard "design" is provided to the participating banks. The repetition is also important to create familiarity. If the brand is not trustworthy enough to attract sufficient investors, the entire plan will fail. So repetition of transactions and standardisation are of extreme importance. Starting this up costs time and money, starting with small issuances growing in number and size over time will in my opinion be necessary to succeed.
In addition, economic feasibility is important in order to make it attractive to actually lend, and securitise these loans for banks. What definitely should change in order to make such a platform viable are regulations, exemptions will have to be made, or perhaps even complete new regulations on participators should apply. Secondly I think it is absolutely necessary that there is government support in order to create and perhaps even sustain such a platform. A complex calculation will have to be made whether the possible gains of such a platform outweigh the costs that governments have to make in order to create and sustain it. Through such a platform, besides decreasing costs, the goal is to change the vision of investors. Rather than being scared of every possible risk, incentives should be present allowing them to see opportunities.

At the top of the platform, is an internationally known, big and stable institution. The institution should be trusted by the public, and in order to achieve and guarantee this, subject to high levels of monitoring/supervision. From here on I will call this the "head institution" as it is at the head of the platform. Because of the huge importance of the ECB, such a head institution can never be the ECB itself, because the head institution should not play a huge role in the economy which the ECB does. What could be thought of however, is that a group of national Central Banks establish a head institution, and all participating Central Banks deposit an amount of money in it (which they will sooner need to be repaid to make it feasible for them). Of course they will have to make sure that the head institution is a separate entity, with bankruptcy remoteness.
Another option is that governments reserve money for this which is deposited on the head institution, in the guise of economic support, or help to the SME sector. These money deposits will definitely be needed in the early life of the platform as there is not enough publicity amongst investors yet, and there will be money needed for the development.

This head institution invests money (which perhaps can be raised from investors) developing a central database, on which the affiliated banks can list their extended loans(so this does not necessarily mean a deposit, only registration). The affiliated banks get access to the database, and are supported by governments to set up IT infrastructure to enable them to participate in this structure. The central database has an overview of what types of loans are extended.

The lending happens at the regular banking level (often regional). In my opinion there are two options: either, these regional banks act as intermediaries, providing these loans from the money present at the head institution (of course capped to regions, countries or banks as resources are not endless). Another option is that the banks extend these loans (so they are on their own balance sheet), In the last case however, the head institution will be the intermediary which will bundle these loans based on the information in the central database after which the bundled loans are directly channelled through the issuance of notes to investors. The last option is better in my opinion because, even though the banks will act according to guidelines and calculations made at the head institution, the lending out of the money of another party can easily create distorted incentives.

The participating banks should be screened carefully, live up to requirements and, in addition, use methods selected by the head institution with rating agency approval to calculate whether or not a certain SME can apply for a certain loan.
The goal is to make the lending by the banks as consistent as possible among all participating banks in order to make sure banks are not able to dump their bad loans on this platform.

In case of distress from the side of the regional bank and in case it needs liquidity, when certain requirements have been met, it can deposit the loans at the head institution, or a second entity is established, which can take over the loans in case of liquidity needs amongst participating banks. The loans are at that time still available at the database and thus can be bundled. However, in case of a second entity, this will also have to be financed.

In such a case of distress described above, the loans can also be sold to, or used as collateral at the ECB up to certain amounts, this is possible because of the superior quality of the extended loans which will be securitised. This enables the banks to fulfil their liquidity needs. Once these loans are used as collateral or sold however, they are still in the database, and can still be securitised through the head institution. Of course there have to be rules governing this, otherwise all banks can extend as much loans as they wish, say that they are in need of liquidity and sell the loans. Because of the repetition (often not too long after each other), the parties taking over these loans will not keep them on their balance sheet for long.

The head institution will provide a template with all data needed. This data will be for example about which SMEs can apply, for what loans they can apply and with what maturity. The entire rulebook of the securitisation is thus created at the head institution.
The loans cannot be registered at the database if even the smallest rule of the template has been broken.
The template contains information on what these loans may look like, and what the requirements are for SMEs. The loans will have standardised amounts (so there is a choice: €1000, €5000, €10.000 etc.). These numbers are just illustrative and can be different based on SME needs.
However, using the numbers I drafted, if an SME needs €3500, it can either choose to borrow 3 or 4 packages of €1000(in the case of 3 it needs to attract additional €500 funding elsewhere), or 1 package of €5000. In the last two cases the SME will have borrowed too much, however provisions are made that once the securitisation transaction has been opened, the unnecessary amount can be paid back (perhaps with an interest settlement), so part of the loan is already paid back at opening.
When being securitised, it could be better if the bundles provided to single SMEs are split up, so the risk per SME is being spread. Furthermore, the SMEs are divided in categories, and will be separated into smaller groups based on, for example, annual turnover, annual profit or something else (SMEs which fall in certain categories, can be capped to a certain amount of money they can borrow: e.g.

the smallest SMEs can borrow max. €5000).
Distinctions will also be made by what kind of SME it concerns, or the sector it operates in, the region or country it operates in, and loan maturity. By this, the central database can easily make distinct bundles of loans, because it has a clear overview of every characteristic of the SME and the loan.
An SPV is created (and if possible maintained for the next issuances), giving out notes to investors and purchasing the relevant loans of the participating banks.

If the participating banks need to retain 5% of the securities of their delivered part for a securitisation transaction because of art. 122a CRD, this can be used for their liquidity buffer. The European Commission has so much confidence in this structure, that the participating banks are exempted from the rule that these securitisations are not usable for their liquidity buffer. In addition, because of the safety of this platform, the capital requirements for these securities should be low.

Of course there will be credit enhancement, in order to further guarantee the quality of the products (by, for example, the European Investment Fund).

This transaction would be a true sale, however it could be even more cost-efficient if this would happen through a synthetic securitisation. On the other hand, it is undesirable that the assets remain on the balance sheets of the banks/head institution, so synthetic securitisation might not be the best option. I think that as long as the rules described in chapter 4 remain unchanged for participating parties (without exemptions etc.), not even the best platform will be able to help SME loan securitisation back on track. As said before, different rules for participating banks are probably needed and perhaps even justified, if the European Commission and/or national governments are involved closely enough with this platform. As long as the participating banks or head institution has to live up to the current and proposed regulations (as discussed in chapter 4), such a platform will not succeed.
On the other hand, taken art. 122a CRD as an example, I think it is important to be extremely cautious with exempting certain participating banks because art. 122a is an incentive for banks to extend good quality loans. The right incentives should not be removed again, in order to stimulate SME securitisation at all costs.

This model will undoubtedly have its problems and difficulties, however it is just a rough sketch of what such a platform could look like. In my opinion, it is inevitable that governments or central banks provide support for starting up.
The platform as I sketched it is too rough to be a working and successful platform that is economically feasible for involved parties. It might however be used as a foundation for other people to think about how such a platform could be created or made feasible.

However, in the context of SME finance, I also would like to propose another kind of platform which is not really about securitisation but could mean an increase in SME lending.
Even though a very negative picture has been created, there still are companies (big and small) with capital on which they would like to make profit. I believe that for some of them, it would be desirable to lend this directly to potential high profit generating SMEs rather than keep it on the bank with a low interest rate. What I am proposing here, is to create a national platform, that directly enables

these companies to lend to SMEs in need of finance. I believe that such a platform would not work as good internationally, because the entire goal is to lend as directly as possible, with as less third parties or intermediaries as possible, in addition this implies transaction costs. Standard loans are provided and there is no negotiation in between these standard loans (for example: € 1000 or €2000 and nothing in between). The SMEs and borrowers are listed on this platform, for the amount of money they wish to lend or borrow and the interest rate they have in mind. The interest rate will be negotiable. However, the interest rate will have to be capped in the regulation, to avoid usurious interests, and SMEs getting themselves in trouble by willing to borrow at all costs. If parties do not come to an agreement, for example when the borrower thinks the risk involved desires an interest above the regulatory maximum, they split up and other counterparties are sought.
Of course this is just a mere sketch of what it could look like. There will always be problems such as the fact that the companies have little insight in the SME positions but, there are also possible solutions. Certain rules would have to be made and SMEs will have to live up to certain requirements. I believe such a platform would be beneficial for SMEs. Because banks stay out of the picture, the lending is not limited by regulatory restraints on banks. If it is not as effective as I think it could be, it could still mean a possible addition to the current finance options in the form of a marketplace where supply meets demand. Perhaps a similar initiative already exists, I did not find any proof of this however.

I hope that through providing my view and some of my ideas, I have made a contribution (as small as it may be) to the discussion concerning how SME finance can be improved. I do not expect my sketches to be perfect as I am not a financial engineer. In addition these are just sketches which are too limited to come anywhere near a complete image. People with a lot more knowledge concerning this topic have thought about platforms as these for years, it would be strange if I could outsmart these persons. But if they could derive even the smallest insignificant element from my view, my goal would be achieved.

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