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Non-Impairment Requirements for High-Quality Securitisation under the LCR and Solvency II will not be appropriate for SMEs

Dear Mr. Faull,

We are deeply concerned that the eligibility criteria for high quality securitisations proposed in the recent draft delegated act on the Liquidity Coverage Ratio (LCR) and on Solvency II could contradict the political aim to revive the securitisation market in the EU, as recently expressed by the European Commission in its communication on long-term financing of the European economy. This is also the conclusion drawn by the International Monetary Fund in its country report on Euro Area Policies released in July 2014 which supports an expansion of the SME securitisation markets and which states that European securitisation markets performed relatively well through the crisis.

Asset-Backed Securities (ABS) and Asset-Backed Commercial Papers (ABCP) are an important source of funding for the German and European real economy. In particular, for larger SMEs it will be increasingly important to use this kind of funding sources to better diversify their financial basis. Meanwhile, also banks will again find it more relevant to use the securitisation market for their funding activities.

The signatory organisations have repeatedly called for a removal of the various regulatory impediments that contradict the development of the European securitisation market. We therefore appreciate that the high economic potential of the securitisation market and the need for a more differentiated regulatory treatment are increasingly acknowledged.

Having said this, we are concerned that disproportionate impairment requirements for the securitised assets proposed in the recent draft delegated act on the Liquidity Coverage Ratio and Solvency II could contradict these much appreciated efforts.

In principle, we agree that credit-impaired borrowers should be excluded to ensure a sufficient quality of the underlying securitised assets. Unfortunately, the definition of impairment is too broad and goes beyond the definition of objective evidence of impairment according to IFRS (see the recent definition of credit-impaired financial asset according to appendix A of IFRS 9 Financial Instruments published on 24 July 2014 that was broadly adopted from IAS 39).

In particular, this concerns the envisaged exclusion of loans and leases with a credit assessment by an ECAI (External Credit Assessment institution) or the internal credit score indicating a significant risk of default. So far it is not defined what is meant by "significant risk of default".

However, according to IFRS 9 published on 24 July 2014, a risk is "significant" if the assessment of receivables is below "investment grade" or an equivalent to this. But it is important to mention that "increased significant risk" does not mean necessarily that there is evidence of impairment according to IFRS 9.

If regulators referred due to a missing regulatory definition of "significant risk of default" and a missing reference to the credit-impairment definition according to appendix A of IFRS 9 to the criteria of significant increased risk in IFRS 9, which is very likely, then not only credit-impaired borrowers according to IFRS 9 but a much more broader base of SMEs would be excluded from high quality securitisation. Especially, the credit rating i.e. scoring of SMEs is often due to the relatively low equity level not "investment grade" or an equivalent to this, even if the company is in good shape and meets its financial obligations.

Thus, if the originating credit institutions or leasing companies were forced to exclude such SMEs from high quality securitisation this would increase the funding cost and finally the financing or leasing costs for the SMEs and thus would have a detrimental impact on their financial situation.

Risks to SMEs are reduced by diversification effects that offset a certain portion of higher single risks. Even if an SME portfolio contains a number of significant single entity risks, the quality of the portfolio might be good due to diversification effects. Such positive diversification effects have already been recognised in the Capital Requirements Regulation (CRR) by more favourable risk weights to determine the capital requirements of SME exposures. Unfortunately, these positive portfolio effects of granular portfolios comprising a large number of SME-loans seem not to be contemplated for the purpose of the LCR and the capital requirements under Solvency II. As stated by the IMF in the above mentioned report securitisations of SME loans performed well in the past.

The problem is aggravated by the fact that originating credit institutions and leasing companies are forced to exclude SMEs with adverse credit history from high-quality securitisation. It is not clear under which conditions a credit history is deemed adverse or not adverse anymore after a company has recovered. Such requirement would prevent the recovery of SMEs after an economic downturn due to increased financing costs even if the company has good credit quality. This adverse impact especially on SME's can't be desirable for the economy in the EU.

Moreover, companies, such as SMEs, that have recovered after an insolvency or debt rearrangement process should not be excluded if they are not impaired any longer according to the applicable accounting rules. Even according to the accounting rules, it has to be assessed after a recovery whether the borrower is still credit-impaired. If this is the case, then such loans would have to be exempted from the securitisation of high quality ABS if there was a clear reference to the credit-impairment definition in appendix A of IFRS 9. According to the current proposal such borrowers would be excluded for three years notwithstanding the current creditworthiness, which would be detrimental to the recovery of such companies.

As a consequence, SME securitisations might not be acknowledged as high quality ABS. Investors will reject to invest in ABS with these underlying assets. The market for SME-ABS will dry up. Obviously, the right balance between the appropriate quality of the underlying assets to be securitised and the political aim and the economic need to promote growth and employment by a smooth financing of companies has not yet been found. Moreover, the too broadly defined impairment criteria clearly contradict the declared objective of the European Commission to promote credit lending to small and medium-sized businesses in the EU by means of securitisation.

To strike the right balance of sound quality of underlying securitised assets and the need of SMEs to benefit from lower financings costs we recommend excluding the following exposures from high quality securitisations:

- Exposures that are in default according to Basel II i.e. article 178 of Regulation (EU) 575/2013.
- Exposures with objective evidence of impairment that are deemed credit-impaired according to appendix A of IFRS 9 requiring a specific provision.
- Exposures that are past due more than 30 days.

Instead of referring to a rating or scoring of an External Credit Assessment Agency or to an internal score we recommend to refer to the actual payment behaviour and to exclude leases and loans that are past due more than 30 days at the time of securitisation. The recommended definition would base on well-proved and well-established standards and would not require a further EBA and EIOPA guideline for clarification and harmonisation across the Member States to be implemented by the national supervisory authorities. Hence, regulatory uncertainty as to which loans and leases will be eligible for high quality securitisation would be stopped, which is important to promote the financing of SMEs via securitisation.

To ensure that no adverse selection of securitised loans and leases is possible and to realize the intended diversification effects in a securitised portfolio, we recommend requiring a random selection of the loans and leases for securitisation from a target portfolio considering the eligibility criteria.

As a result, a sufficient high quality of underlying assets could be ensured without excluding large numbers of medium-sized businesses, which form the backbone of the EU economy, from high quality securitisation. We therefore would kindly request you to give full consideration to making an appropriate adjustment to the non-impairment requirement of the present draft delegated acts on LCR and Solvency II.

Should you have further questions, please do not hesitate to contact Dr. Reinhard Kudiß at the BDI (Tel.: +49 30 2028 1422; email: r.kudiss@bdi.eu) or Dr. Norbert Kuhn at the Deutsches Aktieninstitut (Tel.: +49 69 92915-20; email: kuhn@dai.eu).

Yours sincerely

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