

Corporate finance by way of ABCP programmes under the new EU securitisation regulations



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I. Context: upcoming Level II measures will result in far-reaching adjustments

The new Securitisation Regulation and the corresponding changes to the CRR come into force in early 2018 and have to be applied from 1 January 2019. The securitisation regulation and the amended CRR empower the EBA and ESMA to set regulatory technical standards (RTS) and create guidelines for the practical implementation of the abstract requirements of the new Securitisation Regulation. Precise, practicable RTS and guidelines adopted in a timely manner are crucial to the operational implementation of the regulatory framework for securitisation.

This applies to ABCP programmes in particular, as they are used by companies of the real economy – and not by banks, for example – as ‘*originators*’ through the sale of trade and leasing receivables. If the future RTS and guidelines on securitisation fail to take into account the particular conditions of these companies, which tend to be small and medium-sized, ABCP financing as an established funding model will vanish from the market.

That cannot be the intention. The securitisation of trade and leasing receivables through ABCP programmes has grown strongly in the past ten years and is today being used by a large number of companies in Germany to finance working capital with around EUR 20 billion per annum. The instrument is therefore ideally suited to fulfil the aspiration and aims of the EU capital market union project to make corporate finance more crisis-proof and independent from bank loans.

Having conducted intense discussions and research with affected SMEs and financing ABCP banks, we outline below

- a description of the most important regulatory areas, and
- possibilities for concrete, practicable and risk-adequate solutions.

Here it must be noted that, in a typical ABCP financing, the ‘*sponsor*’ bank assumes all the financial risk from the acquired trade and leasing receivables and the CP investor is fully protected from losses (‘*comprehensive cover model*’) – unlike in other forms of securitisation.

II. An overview of the most important regulatory areas

The new EU regulatory framework extends the previous regulatory system for securitisations in significant aspects. Moreover, it creates a securitisation segment with regulatory privileges, known as STS securitisation. STS stands for standardised, transparent and simple.

Regulatory areas for all ABCP financings

1. No cover for the risk retention
2. Transparency requirements
3. Lending standards

Additional requirements for STS-ABCP financings

4. Securitised receivables must be homogeneous
5. Originator must be located within the EU
6. Risk concentration requirements
7. Debtors with an 'impaired' credit history

For every sponsor bank, but also for bank investors in ABCPs, it is highly important that a transaction and, if possible, the programme itself reaches STS status. On average, ABCP transactions are currently within the A rating tier. The liquidity line made available by the sponsor bank thus has an RWA ratio of around 20%. Even if all STS criteria are met, under the new regulation the RWA ratio will increase to around 30-40% and – if the STS criteria were not met and the transaction were to become non-STS – would even surge to above 60%. That, however, would compromise the profitability of the transactions, particularly because it might lead to the paradoxical result that an unsecured financing through a credit line from the bank would suddenly be more advantageous from a regulatory aspect than the fully secured ABCP financing. In this context, it must be borne in mind that the regulations would affect not just high-end SMEs. As ABCP programmes contribute nearly EUR 10 billion and, thus, some 20% to the funding of German leasing companies, and since it is particularly the smaller and medium-sized companies that rely on leasing to finance investments, the regulations would affect the full spectrum of the German SME sector.

III. Detailed analysis and possible solutions

1. No cover for risk retention

In the securitisation of trade receivables, trade credit insurers ('*CE policies*') play an important role. They typically provide a portion of the cover otherwise provided by the originator and in this way reduce the cost of the transaction for the originator. They cover the securitised portfolio of receivables almost completely so that the sponsor bank and the CP investors have additional protection against bad debt losses. Because the liquidity line provided by the sponsor bank counts as risk retention but may not be secured, a narrow interpretation of the regulation wording could mean that such trade credit insurance might become inadmissible.

Suggestion:

It should be clarified that CE policies will not be classified as cover for the risk retention. Otherwise, trade receivables in particular could no longer be used for corporate finance.

2. Transparency requirements

The data and contracts underlying trade receivables are usually business secrets for industrial and trade companies. They contain, for example, payment terms and discount arrangements, client-related agreements and default rates which no enterprise wants to disclose to the public – and hence to its competitors.

Because of the character of an ABCP programme (full risk coverage by the sponsor bank), this does not interest any investor or other third party either. The sponsor bank which bears the primary risk, on the other hand, has access to all detailed information - and so does the regulatory authority.

Suggestion:

In ABCP programmes with full risk assumption by the sponsor bank, the transparency requirements (Art. 7 and Art. 22) are fulfilled by the publication of the programme structure and the established investor report.

3. Lending standards

Various sections of the Securitisation Regulation require that all the credits be granted '*... on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits*' (Article 5.1.(a)) and '*that credit-granting is based on a thorough assessment of the obligor's creditworthiness*' (Article 9). The terms used clearly demonstrate a focus on the (already highly regulated) credit lending process in banking and not on the challenges of industrial companies. The exception put forward in Recital 14 has unfortunately not been included in the text of the Regulation so that there is a need for clarification.

Suggestion:

It should be clarified that it is sufficient for companies of the real economy to implement industry-specific processes designed to verify a customer's ability to pay. These processes are submitted to and assessed by the sponsor bank prior to the purchase of a receivable under an ABCP programme.

4. Homogeneity requirement

The homogeneity requirements set forth in paragraph 15 of Article 24 must be understood and interpreted against the background of the specific asset types. As outlined in Recital 27, homogeneity simplifies the risk assessment for the investor. The sponsor bank bears the full primary risk through its liquidity line, as outlined under item 2 above (transparency requirement). At the level of the ABCP investor, therefore, there is no need for analysis beyond the customary credit risk reports. At the level of the bank providing the liquidity line, however, which is not always necessarily identical to the sponsor bank, a narrow definition of homogeneity would not provide any further security because transparency already exists at the level of the individual exposure. Moreover, German SMEs come from all branches of industry and deliver to all corners of the world. In other words, we are dealing with the most diverse customer demands, jurisdictions and legal systems. Any narrowing of the admission criteria through the homogeneity requirements would thus inevitably lead to unprofitable transaction volumes and make the instrument disappear from the market. This

cannot be in the interest of the Regulation, which precisely aims to promote alternatives to SME finance.

Suggestion:

Where companies of the real economy participate in an ABCP programme, no unfulfillable demands should be imposed on the 'homogeneity' of the pool of underlying exposures sold. It should be clarified that a homogeneous portfolio exists every time the exposures originate in the established business field of the enterprise of the real economy. The enterprise should be able to determine and justify individually what factors constitute such a business field.

5. Originator's location within the EU

Export-oriented companies often sell their products through foreign sales subsidiaries that generate the invoice and recognise the exposure in their balance sheet. In the meaning of the Securitisation Regulation, these would have to be regarded as the originators, i.e. the holders of the asset.

In accordance with Article 18, however, the originator of an STS transaction must be domiciled in the EU, which means that such sales subsidiaries' pools of underlying exposures cannot be involved in an STS transaction – to the extent they are domiciled in a non-EU country.

Suggestion:

Non-EU subsidiaries of EU companies that conduct securitisations via an ABCP programme should be recognised as EU originators if the seller risks (i.e. essentially transfer and verity risks) are appropriately covered by the parent company.

This could be done, for example, through corresponding guarantees or letters of comfort.

6. Risk concentration requirements

Article 243(1)b CRR imposes concentration limitations on the ABCP portfolio at programme level. Thus, a debtor or associated debtor may not hold more than an aggregate 2% of an ABCP programme (if not covered by trade credit insurance). What is customary practice in banks

through borrower units etc. can, unfortunately, hardly be realised in trade and leasing receivables from various sellers because no corresponding links exist between different customers and an associated debtor (in the meaning of the CRR) and it is not possible to generate debtor overlaps nor debtor units across the various sellers. It is therefore not possible in practice to ensure these concentration limitations at programme level. The only practicable option for determining a concentration limit would exist at the level of the transaction. However, a 2% limit at this level would be much too conservative and would drastically restrict the ABCP securitisation potential of trade and leasing receivables of the real economy.

Suggestion:

To the extent that a concentration limit is not identifiable at programme level, the concentration limit of 2% transaction level should be applied only if the exposure of that debtor (or debtor unit – where known) exceeds a threshold of 0.25% of the attributable equity of the sponsor bank. A corresponding threshold value already exists in the large-scale credit sector, where it is regulated that, in the context of the look-through, the sponsor bank is required to attribute an unidentified debtor to what is referred to as the 'unknown client' only above that threshold. Accordingly, an imposition of the concentration limit at transaction level under Article 243(1)b of the CRR should also follow the CRR provision for large-scale loans.

7. Debtors with an impaired credit history

Under Article 24.9, exposures may be securitised only if, to the best of the originator's or original lender's knowledge, the debtor has been neither declared insolvent or undergone a debt restructuring process ('impairment test') within three years prior to the securitisation. Companies of the real economy, however, do not have the possibilities and tools of a bank to verify their customers' credit history over a three-year period in their trade relations. They must rely on up-to-date credit checks or (blanket or individual) protection under trade credit insurance policies. Their best knowledge (as per Recital 26), in this case, is far more limited than that of a bank.

Suggestion:

Satisfaction of the provisions of Article 24.9 including the interpretation of the '*best knowledge*' standard should apply to ABCPs taking into account of the limited possibilities and circumstances of the real economy.

IV. To summarise:

The securitisation of trade and leasing receivables is a successful financing instrument for high-end SMEs that has proven its worth across financial and business cycles over the past twenty years. STS regulation may aid significantly in further expanding the acceptance of the EU capital market union project in the real economy and promoting its attractiveness among sponsor banks.

But this requires the existing STS Regulation to be interpreted with foresight and in line with market requirements. We hope this paper and our suggestions will contribute to achieving this goal.