ECB ABS purchases: expanding the toolbox

- Prohibitive funding costs for small and medium-sized companies (SMEs) are one of the obstacles to an end of the recession in the Eurozone periphery. Spanish and Italian SMEs still pay roughly 200bp more than their German counterparts, although the ECB’s safety net OMT has contributed to lower funding costs since last summer.

Part of the higher funding costs is justified by the impact of the ongoing adjustment recession on companies’ balance sheets, but banks in the periphery are also trying to de-risk their balance sheets by restricting credit to SMEs.

- The ECB is worried about this “credit crunch”. Healthier banks from the core Eurozone are not stepping into the breach either. This fragmentation of the Eurozone’s financial markets impairs the transmission of the ECB’s ultra-low interest rates to the real economy in the periphery.

- To boost SME lending, the ECB is already accepting securities backed by SME loans as collateral in its liquidity operations. More could be done: the ECB could lower its collateral requirements further or allow national central banks to ease collateral rules at their own risk.

- However, there may also be a case for bypassing the banks if those in the periphery are too weak and those in the core too shy to step in. State investment banks traditionally play this role with a range of products. By fostering the securitisation of SME loans into ABS, public capital markets could also play a bigger role.

- At the 2 May press conference, ECB President Draghi hinted at a new Eurozone initiative to boost the securitisation of SME loans. He also hinted vaguely that the ECB could purchase ABS on secondary markets in the future, but he emphasised that the ECB’s thinking was at a very preliminary stage.

- As a prerequisite for possible ECB ABS purchases, deep and efficient markets for such ABS in the Eurozone have to be created. Experience shows this is complex and takes time, even at a national level. Before the global financial crisis, there had been several initiatives to boost the securitisation of SME loans at a national level – for instance, the German True Sale Initiative (TSI) – many of which undershot expectations.

- The ECB could play a role as a catalyst for SME loan securitisation, but the key players will be the EU for regulation and European and national development banks for packaging, certification and guarantees.

- Expectations that the ECB could buy SME loans directly from banks soon are unrealistic. The ECB may eventually buy ABS on the secondary market, but even that may take a while.
Prohibitive funding costs for SMEs remain an obstacle for a return to growth in the Eurozone periphery. To fully exploit the cost advantages created by wage restraint and job shedding over the last few years, more private investment would be needed. The ECB has acknowledged the necessity for improved SME financing and has hinted at a new Eurozone SME loan securitisation initiative. But expectations that the ECB would buy loans directly out of banks’ balance sheet are unrealistic. The ECB may eventually buy ABS on the secondary market, but even that may take a while.

SME funding costs have decreased in the periphery since summer 2012, when the ECB imposed its OMT safety net and thus greatly reduced the tail risk of a Eurozone break-up due to financial market panic (see Chart 1). But the decline in SME funding costs has not matched that of sovereign borrowing costs. The difference in borrowing costs between Germany and the periphery has even increased.

With the catastrophic tail risk diminished, two main reasons for the different funding costs between Germany and the periphery remain: first, the ongoing adjustment recession makes companies in the periphery the riskier investment (this explains why funding costs remain high); second, banks in the periphery are trying to de-risk their balance sheets by restricting credit to SME loans. The flight to safer assets may explain why funding costs in Germany have decreased so much.

The ECB has acknowledged the SME funding problem. Of course, SMEs in the Eurozone periphery have to deal with their business risks themselves, raising capital where necessary. But the ECB is worried about restrictive lending by periphery banks, and healthier banks from the core Eurozone have not stepped into the breach. The ECB calls this financial fragmentation, which impairs the transmission of its ultra-low interest rates to the real economy in the periphery.
If periphery banks are too weak and core banks too shy to step in, there may be a case for bypassing the banks. But that poses a challenge: in the Eurozone, 80% of funding is done via banks, according to Draghi, and only 20% via financial markets. Securities backed by SME loans are hardly traded in public capital markets at all. Determining a fair price for the SME loans on banks’ books is next to impossible for the central bank. Accepting such loans as collateral may be possible with a steep haircut, but buying them outright is not. To increase price transparency, the ECB now wants to promote the securitisation of SME loans on a Eurozone level, so that they can be publicly traded.

Before the global financial crisis, there had been several initiatives to boost the securitisation of SME loans at national level, for instance the German True Sale Initiative (TSI). The fact that TSI was launched in 2004 at the height of the Agenda 2010 economic reforms highlights that such projects tend to receive political support in times of crisis, when banks are seen as too timid. However, these initiatives usually fell short of expectations in terms of SME lending support. TSI has had 80 transactions since 2004, some of which were in car loans not in SME lending. ABS products also took a reputational hit, as structured products were partly blamed for exacerbating the global financial crisis.

So what can the ECB do? Central banks traditionally do not play a direct role in SME financing. This is the realm of state-owned development banks like Germany’s KfW. These banks can have a wide range of products, from direct lending via cheap bank refinancing to support for securitisation schemes. They can choose to take risks and are subject to public scrutiny.

Central banks can play a role, too, by accepting securitised SME loans (ABS) as collateral in liquidity operations. The Bank of England’s Funding for Lending Scheme is a recent example. The ECB already accepts a very wide range of securities backed by SME loans as collateral in its monetary operations. It has recently acted on this front, too: since 22 June 2012, the ECB accepts ABS backed by SME loans with an investment grade rating and a “haircut” of 26%.

For some members of the ECB, accepting SME loans as collateral does not go far enough. On 2 May 2013, Draghi pointed to other options: “One is collateral, and the second set has to do with purchases of assets.” But what assets to buy? As Draghi pointed out, the ECB cannot buy loans directly off banks: “The ECB cannot clean banks’ balance sheets”. So it can only be purchases on secondary markets, with transparent pricing mechanisms. These markets, which would increase transparency of such ABS products, would be a pre-requisite for the ECB to get involved.

As a consequence, Draghi spoke vaguely of initiatives to boost securitisation of SME loans on a European level. The obstacles are substantial: mistrust between banks about what is being packaged into ABS is the key impediment. Involvement of regulators is inevitable. So Draghi hinted that the EU Commission and the European Investment Bank might play a role in the packaging, certification and guaranteeing of such products.

The ECB role in promoting a European ABS market would be that of a catalyst, highlighting the need for it as a means to bypass the banking system for monetary policy purposes. But the role of governments and the...
EU would be far greater. The EU would have to define and regulate products, European and national development banks could package and guarantee them. So far, this potentially huge project is not even being discussed, although a small Reuters news item last week that Germany and Spain were discussing ways to cooperate on SME lending suggests that there is some appetite for cross-border support.

A vast pan-Eurozone SME loan securitisation initiative could be very good news, but it would take a lot of time. The founding of the German TSI was a complex process involving many banks, the public development banks and government regulation. Its success was far more limited than initially planned, even in a very benign financial market environment. Years may pass before the ECB could realistically purchase such instruments in a meaningful way in emergency situations.

Just like the banking union, a securitisation initiative could be an element to better prepare the Eurozone for future financial crises. But if Eurozone governments cooperate better to improve lending to SMEs, for instance by allowing national development banks to support cross-border arrangements, a first step to reducing the fragmentation of financial markets could be taken. The June EU summit could be the venue to launch the discussions, supported by the ECB.

ECB asset purchases on secondary markets may be years away

EU summit could launch initiatives to support SMEs
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