

Strategy for revitalising the securitisation market

Premium segment for German small and medium-sized enterprises (SMEs)

PRELIMINARY REMARKS

Many of the prerequisites for a premium German SME securitisation segment currently discussed by market participants and policymakers are already met. This goes particularly for requirements concerning the quality of the securitised loans. Most securitisations of loans to German SMEs have always been balance-sheet transactions. This means that, unlike the originate-to-distribute model especially widespread in the US, the underlying loans are already on the books of the originating bank prior to the securitisation process. As a result, the securitised loans are subject to the same lending standards and approval processes as those applying to loans which remain on the bank's balance sheet. In most cases, further business relations also exist between the bank and the debtors of the securitised loans, which aligns the interests of the originating bank and the investor even more closely. For these reasons, German SME securitisations are already of a high quality. Even in the current financial crisis the defaults on balance-sheet transactions have normally remained within the boundaries of expected losses and have not exceeded the level of the first loss piece.

Appropriate, mandatory standards for the new premium segment will be established on the basis of these existing characteristics of German SME securitisations. These standards are intended to achieve the following objectives:

- to align the interests of originating banks and investors beyond the regulatory retention requirement,
- to guarantee the quality of the underlying loans and of lending, approval and servicing processes,
- to ensure the greatest possible transparency: new transparency requirements will ensure that investors obtain detailed and, to the greatest extent possible, standardised information about the securitised loans and their development over the life of the securitisation.

To this end, the German private banks will apply the requirements of Article 122a of the Capital Requirements Directive to premium segment securitisations before these provisions officially take effect.

Developments at European level – especially in the European Financial Services Round Table (EFR) – will be monitored and relevant standards will be adopted.

STANDARDS

The following minimum standards shall apply to the premium segment of securitisations of portfolios of loans to German SMEs:

Quality of the underlying exposures

1. In addition to loans in the narrow sense, credit lines and guarantees may also be securitised. By contrast, the securitisation of subordinated financing (so-called mezzanine securitisation) shall not be permitted. The portfolio shall not contain any securitisation positions of other securitisation transactions (resecuritisation is prohibited).
2. The debtors shall be German small and medium-sized enterprises (SMEs)¹.
3. The bank shall apply the same lending standards, approval processes and incentive policies to loans which are later securitised as it does to loans which remain on its balance sheet. This means that the loans to be securitised are not subject to diverging lending standards or approval processes.
4. The loans shall have been granted in the course of the bank's normal business activities and shall be on its balance sheet (so-called balance-sheet transactions). Loans granted using diverging lending standards and approval processes for the express purpose of immediate securitisation and placement in the capital market (so-called originate-to-distribute model) shall not be securitised.
5. To further align the interests of the investors and the bank, the bank may securitise its total lendings to a single borrower only if the loan assets have been on the bank's balance sheet for at least one year.
6. After securitisation, loan servicing shall remain the responsibility of the bank or, in the case of syndicated loans, the responsibility of the agent bank and shall continue to be subject to the bank's servicing standards.

¹ For the purposes of these standards, "SME" covers any company which is not a regular issuer in the capital market; "issuing" does not include the acquisition of liquid funds by means of syndicated loans. The issuing prospectus will classify the debtors/borrowers in the securitised portfolio by annual turnover.

7. The portfolio of loans to be securitised should be representative in their specified selection criteria of the relevant product segment of the bank's business with SMEs.² This can be ensured, for example, by cluster analyses of the reference portfolio and of the product segment in question with respect to the distribution of measures of creditworthiness, maturities, geographical regions, etc., which should be comparable on average.
8. The loan portfolio to be securitised should be granular and diversified with respect to individual borrowers, industries and geographical areas.² For the purposes of this standard, granular means that the portfolio to be securitised includes a yet-to-be-specified minimum number of individual borrowers (or groups of borrowers) and contains no concentrations with respect to lending volumes.
9. Only loans which are performing³ when selected for inclusion in the securitisation portfolio (cut-off date) shall be securitised. The period between the cut-off and the closing date shall not exceed three months. Loans which are non-performing on the closing date shall be removed from the portfolio to be securitised and, if replenishment has been contractually agreed, replaced with other loans that fulfil all selection criteria.
10. The requirement in no. 9 shall also apply to loans which are incorporated into the securitisation at certain specified times to replace other loans (replenishment).
11. The requirements for originators set out in the new Article 122a of the Capital Requirements Directive shall be applied before they officially come into force. In particular, the bank shall retain a material net economic interest of at least 5% over the life of the transaction in a form permitted by supervisors.⁴
12. The bank shall have appropriate procedures in place to monitor the performance of the securitised loans on an ongoing basis and in a timely manner. Details of the observed development of the securitised loans shall be published in the investor reports.
13. The bank shall take appropriate steps to ensure, and shall guarantee in its representations and warranties, that the securitised loans are monitored as diligently as are its non-

² The bank may diverge from this standard if investors, e.g. development banks, require concentration on certain geographical regions.

³ Technical delinquency of up to a maximum of five days will not cause the criterion to be breached.

⁴ Increasing the mandatory retention amount (from 5 to x%) is not an appropriate means of ensuring the quality of the underlying loans and aligning the interests of originators and investors. The banks normally have long-standing business relations with the companies and usually hold further loans to the debtors in question on their balance sheets – over and above the required retention amount.

securitised loans. Aside from retaining an economic interest, further possible ways of ensuring this point are

- to refrain from indicating to the loan servicer which loans have been securitised or
- to allocate posted collateral on a pro-rata basis to the securitised and non-securitised components of a client's borrowings to the extent that this is permitted by the security purpose declaration, the loan agreements in question and by any relevant product-specific features and special banking practices⁵.

Structure

14. The securitisation may be a true sale or a synthetic transaction.

Transparency/disclosure

15. In the issuing prospectus and investor reports, banks should generally use standardised definitions of those terms which will make it easier for investors to make a comparison between different issuers. These definitions should be based on definitions specified at European level if these can be applied or adapted for application to German SME loans.

16. The bank shall prepare the preliminary (or so-called red herring) prospectus with the possible assistance of a lead manager and make it available to potential investors at least two weeks before the closing date. The preliminary prospectus shall contain all material information.

17. At a minimum, the bank shall provide investors and potential investors with the information necessary to analyse and evaluate the investment within the meaning of Article 122a(4) and (5) of the Capital Requirements Directive. The **standardised interpretation** of the disclosure requirements set out in Article 122a shall be as follows:

- a) The following information shall be made available to potential investors in the issuing prospectus, among other things, for evaluation purposes prior to making an investment decision:
 - details of lending standards and approval processes, and of incentive and management policies for the main parties involved in the securitisation process,
 - the size of the securitised loan as a proportion of overall outstanding lending to the borrower,

⁵ Development loans, for example, are often given priority when collateral is assigned even if it has been provided to secure all present and future claims.

- description of the types of product which have been securitised⁶,
- description of the criteria used to select loans for the portfolio to be securitised,
- turnover category of the debtors/borrowers in the securitised portfolio,
- industry diversification (on the basis of the first two levels of the Federal Statistical Office's German Classification of Economic Activities (WZ) or the international Nace Code or the industry codes of a credit rating agency),
- geographical diversification (based on Federal *Länder* or the first two digits of the German postcode),
- level and composition of the retained net economic interest,
- description of the treatment of overdue loans (servicing, reminder and recovery procedures, etc.),
- list of comparable past transactions over the previous five years at least⁷ and reference to relevant investor reports on the basis of which the bank's reputation/experience as an originator/servicer and the performance of past transactions may be evaluated,
- description of contractually granted rights of early repurchase of the portfolio and early redemption of the securitisation transaction or mandatory termination of the transaction (early termination trigger),
- details of excess spread if used as credit enhancement in the transaction,
- if relevant, description of the procedures used to value collateral.⁸ It is not feasible at present to standardise procedures for valuing collateral and assessing its mitigation effect. Descriptions will therefore normally be bank-specific.

b) The following information about the securitised loans shall be disclosed to investors in aggregate form:

- confirmation/development of the retained net economic interest,
- details of the performance of the securitised loans in the reporting period, especially the percentage of loans more than 30 and 90 days overdue, the default rate and – if relevant – the percentage of loans in foreclosure,
- percentage of early repayments,
- frequency distribution of measures of creditworthiness or credit scores (including mapping of internal ratings to external ratings of a credit rating agency or explanation of the method used to calculate internal ratings),

⁶ The minimum degree of detail of such descriptions may be standardised at a later date.

⁷ New issuers may instead use equivalent historical data from their own books.

⁸ Collateral does not play a major role in some SME securitisation transactions.

- industry diversification (on the basis of the first two levels of the Federal Statistical Office's German Classification of Economic Activities (WZ) or the international Nace Code or the industry codes of a credit rating agency),
- geographical diversification (based on Federal *Länder* or the first two digits of the German postcode),
- details of excess spread if used as credit enhancement in the transaction,
- current status of specified triggers,
- projected payment flows of the securitised loans (broken down for true sale transactions into interest and repayment) and
- if relevant, the type and value of any collateral. It is not feasible at present to standardise procedures for valuing collateral or assessing its mitigation effect. Descriptions will therefore normally be bank-specific.

The investor reports shall be published in English at least once a quarter and shall be made available to all market participants (a charge may be made to cover costs).

In addition to the aggregate data in the investor reports, the following anonymised information shall be made available on a loan-by-loan basis:

- details of performance in the reporting period, especially whether overdue (by more than 30 or 90 days) or in default,
- for loans in default: details of loss and recovery amount,
- measure of creditworthiness or credit score (including mapping of an internal rating to an external rating of a credit rating agency or explanation of the method used to calculate the internal rating),
- first two levels of the code of the Federal Statistical Office's German Classification of Economic Activities (WZ) or the international Nace Code or the industry code of a credit rating agency,
- federal state (*Land*) in which the borrower is located,
- payment flow (broken down for true sale transactions into interest and repayment) and
- if relevant, the type and value of any collateral. It is not feasible at present to standardise procedures for valuing collateral or assessing its mitigation effect. Descriptions will therefore normally be bank-specific.

Loan-by-loan information shall be made available in an electronic form which enables further processing. This information shall be based on the data requirements of the available quantitative (tranching) models of at least one of the three established credit

rating agencies as long as publication of this information does not violate data protection rules or banking secrecy.

18. The loan-by-loan data mentioned in no. 17 should be made available on request, subject to data protection and banking secrecy considerations, to third parties commissioned by potential investors to carry out a risk analysis.
19. Requests by investors for information beyond the standard information mentioned above should be considered on a case-by-case basis; any additional information provided shall be made available to all investors.

The above disclosure requirements reflect the needs expressed by investors for information which will enable them to evaluate the risks associated with a securitisation. By providing this information, banks in their capacity as investors will satisfy the requirements of Article 122a(4) of the Capital Requirements Directive. This will also enable extensive stress tests to be conducted for the payment flows of the securitised loans.

Valuation and risk assessment

20. The lead manager(s) of a transaction shall make available regular valuations of the tranches as well as indicative prices for the senior tranche.
21. In the course of the structuring process the originator and potential investors shall agree on whether a third independent institution, e.g. a credit rating agency, will also be needed to evaluate the transaction and on its suitability for this purpose in light of the characteristics of the specific SME portfolio in question.

Monitoring

22. Compliance with the standards shall be certified by a central organisation, e.g. True Sale International (TSI), prior to issuance of the securitisation and shall be regularly monitored over the life of the transaction.
23. The central organisation shall compile a list of certified transactions.