afme/
Finance for Europe

Press release

Funding to European corporates and SMEs at risk from Basel III regulatory changes finds new study

22 November 2022

The Association for Financial Markets in Europe (AFME) has today published a study, commissioned from Risk Control Limited (RCL), examining the impact on the European securitisation market of the introduction of the Standardised Approach (SA) Output Floor. This rule change forms one of the final elements of the Basel III set of reform measures and will affect how banks calculate their risk-weighted assets, the denominator in their capital ratio.

The study finds the effect of this rule change, as currently proposed, will vary considerably across regulatory asset classes. Notably, the study shows securitisations of large corporates and SME loans are likely to be severely negatively impacted, making them scarcely feasible. At the same time, securitisations of consumer loans, including residential mortgages, auto loans and other consumer loans, may be boosted.

Shaun Baddeley, Managing Director of Securitisation at AFME, said: *"It is very concerning that securitisations of bank loans to SMEs and corporates are likely to be largely eliminated should the SA Output Floor be introduced in 2025 in the EU as part of the Basel reforms. The uncertainty created by its implementation may cause many issuers to immediately stop using significant risk transfer (SRT) as a tool to transfer risk and free up capital. This could hold back the tool's potential to support the European economy at a time when it is under severe pressure from tightening monetary conditions.*

"We are therefore calling on policy makers to urgently review these rules to support bank lending to corporates and SMEs. To illustrate the importance of SRT transactions, last year in Europe, this tool freed up capital which could be used to support more than EUR 80 billion of lending, representing nearly 10% of SME lending in 2021. It therefore has an important role to play in lifting Europe out of recession and supporting Capital Markets Union objectives.

"Our study also highlights the contradictory effects that this rule change will have, meaning that while securitisations of SMEs and corporate loans are unfairly penalised, securitisations of consumer loans will be boosted. This demonstrates that these rules are not soundly rooted in an understanding of the relative riskiness of different asset classes."

William Perraudin, Managing Director at Risk Control Limited, said: "*We show that sub-sectors are affected differently depending on a 'horse-race' between the effects of floors on the underlying assets and on the securitisations themselves. Securitisations of corporate loans in Europe will be more or less precluded under the new regime. This will occur just at a time when the coincidence of rising capital charges and economic downturn will make the safety valve of securitisation particularly important. Such unintended consequences appear to be a general feature of the current securitisation regime. While problems may be ameliorated by provisional adjustments, what is really needed is a review of central aspects of the approach at the Basel level*."

Among the key conclusions of the analysis are:

- Corporate securitisations, both for large corporates and SME portfolios, will be largely eliminated by the introduction of the SA Output Floor as currently envisaged. This could contribute to a significant reduction in the availability of bank funding to European firms.

- Existing transactions done for risk management purpose, especially corporate ones, are likely to fail the significant risk transfer (SRT) test applied by European supervisors and therefore will have to be terminated. Some of the negative effects of the SA Output Floors on existing transactions would be substantially mitigated if internal ratings-based (IRB) approach banks were required to evaluate SRT tests only at an IRBA level, even if the SA Output Floor is binding.

- The SA Output Floors regime will encourage greater securitisation activity in residential mortgage and other retail loan portfolios because the increase in capital for loans held on balance sheet will exceed that of securitised assets.

- These findings suggest that the implementation of the SA Output Floors will disfavour one asset class substantially while benefiting another asset class with no clear rationale based on policy priorities. This is a consequence of adopting regulatory rules that are not soundly rooted in an understanding of the relative riskiness of different asset classes.

- Overall, the analysis of the study reveals the significant mis-calibration of the SEC-IRBA and SEC-SA for mezzanine tranches and a misalignment of senior tranche risk weights in comparison to pool risk weights. It, therefore, contributes to the case for reconsidering the level of capital charges for such tranches.

AFME suggests an immediate recalibration of the SA Output Floor is particularly urgent to mitigate the severe negative impact outlined. The Association strongly supports proposals by MEPs for a transitional arrangement, until a wider review of the framework is undertaken. This transitional measure is critical for the economic viability of synthetic on balance-sheet transactions, the main instrument used to share risk and redeploy capital into lending to SMEs, corporates and project finance, as they are the most severely impacted by this rule change.

- ENDS -

AFME Contact
Rebecca Hansford
Head of Media Relations
rebecca.hansford@afme.eu
+44 (0)20 3828 2693
+44 (0)7825 081 686

About AFME:
AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical

knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.
Follow us on Twitter @AFME_EU