

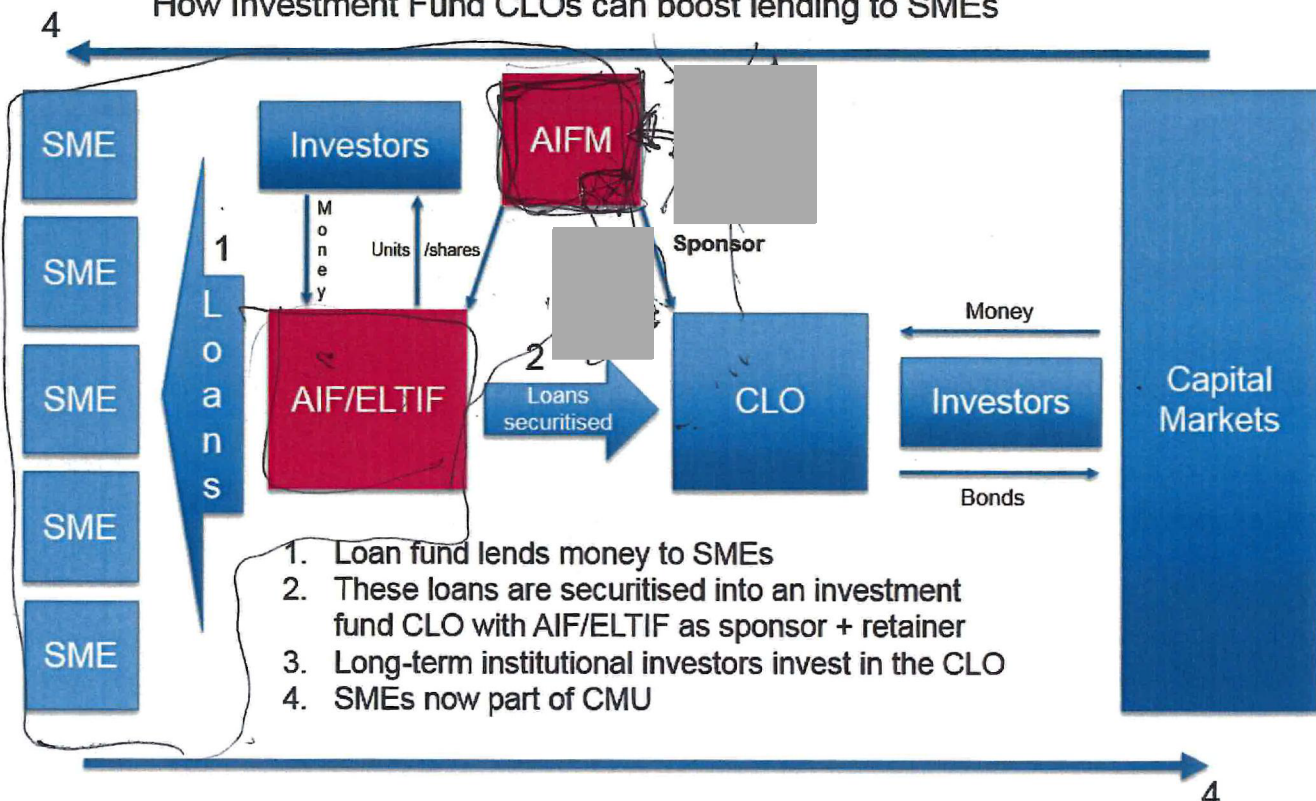
The Case for CLOs in Capital Markets Union

Europe's SMEs are currently unable to access capital markets leaving them over-reliant on bank lending- CMU must be about connecting SMEs to capital markets.

- SMEs are responsible for 99 out of every 100 businesses, two in every three employees and 58 cents of every Euro of value added of the business sector. They need greater diversity in the supply of finance to support them.
- Bank loans currently represent 80% of Europe's corporate debt and it was this dependence that created the conditions for credit crunch and hampered subsequent growth.
- We estimate only 6% of SME finance is currently securitised but if we can increase the percentage of SME loan securitisation back to its pre-crisis peak of 9.3%, and in parallel increase the participation of alternative lenders in the market, we can significantly increase the stock of SME finance in the EU by at least €90bn.
- SME securitisations are highly concentrated in the banking sector with 95% retained by credit institutions
- Rejuvenating the securitisation market, in particular for Europe's collateralised loan obligations ('CLOs'), will help finance the recovery and inject greater stability in the system by decreasing European borrower's dependence on banks as their lifeline to funding.
- In 2014, CLO issuance in the US was \$124bn as against €14bn in Europe.
- Alongside CLOs, Investment Funds already provide loans directly to EU corporates through various fund structures and soon, via ELTIFs, will be able to do more. We estimate that, within 5 years, somewhere between 15% and 20% of corporate funding could come from such loan and private debt funds.
- If the entities that manage those funds were able to easily fund those loans in the capital markets and offer them to institutional investors as CLOs, this will deepen the lending capacity of these alternative and regulated providers of finance to Europe's corporates
- CLOs performed well during the crisis with five-year cumulative investment grade loss rates on CLOs under 1%.

As Commissioner Hill said in his CMU speech on 3rd December, "in the US, SMEs get about five times as much funding from the capital markets as they do here".

How Investment Fund CLOs can boost lending to SMEs



The Securitisation Regulation as drafted will not deliver this and leaves SMEs to continue their dependence on a bank centric model of finance.

It is a missed opportunity as it will not allow investment funds to manage CLOs. In contrast to the stated aims of CMU, the securitisation market will continue to be dominated by banks.

What needs to change:

The current definition of sponsor should be adjusted to allow EU AIFMs, other non-CRD IV¹ investment managers and UCITS management companies to be the retaining party. Without this change, only Banks will be able to act as sponsor and the CLO market will remain concentrated in the banking sector.

- The purpose of risk retention rules is to ensure that loans are not packaged and sold by originators, which absent 'skin in the game', could be done with undue regard for underlying risk.
- The CLO manager is effectively, for the purposes of risk management, the originator and sponsor, as they select and package up the loans to be securitised and sold.
- They should also therefore be the 5% retaining party to ensure they are incentivised to select and manage the performance of the loans
- The manager is then under a specific set of incentives both to package loans with due attention to risk, as well as to manage the portfolio of those loans to maximise returns to both them and, more importantly, their investors.
- Unlike other securitisation structures, the fees for the servicing role undertaken by CLO managers is explicitly performance based. Given that this structure solves the original concern and motivation of risk retention rules and inherent concerns on financial stability, the regulation needs to properly reflect these nuances so as to allow CLOs to better fit within the rules. This means that performance fees should count towards the 5% retention allocation.
- In our view, EU AIFMs, other non-CRD IV investment managers and UCITS management companies should be capable of qualifying within the "sponsor" definition given that a number of such managers already operate in the market and have active and tested experience of establishing and managing CLOs.

¹ Directive 2013/36/EU.