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# Covered bonds Special

## European Secured Note: new dual recourse instrument



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### Key points

■ **What is in the name?** The European Secured Note (ESN) has been designed by the ECBC in response to the EU Green Paper on Building Capital Markets Union. **ESNs are designed to provide a funding instrument that sits between traditional covered bonds and high-quality securitisations.** The ECBC outlines **two possible implementation structures** for the ESN. The first is an **on-balance sheet ESN** (considered a covered bond look-alike), with a dynamic pool and dual recourse to the bank raising the funding. The second is an **off-balance sheet dual recourse instrument** with a static pool, which could provide capital relief as well as promote risk transfer and risk sharing.

■ **What is needed for the instrument to develop?** For the ESN product to develop, the market would require a **standardised definition** of an SME or other underlying qualifying collateral, and these common quality and eligibility features should be implemented across Europe with the same criteria. ESNs should benefit from pan-European standards and favourable regulatory treatment. In our view, the **public supervision** of this product, **together with UCITS eligibility, will be crucial for market acceptability** as it would pave the way for favourable regulatory treatment (e.g. eligibility for LCR purposes, Solvency II, ECB and Bank of England repo, CRA III Regulation). **Transparency** of data is also key.

■ **Rating agencies have commented on the proposals.** Fitch has said the on-balance sheet ESN could be rated under its existing 'Covered Bonds Rating Criteria' and the capital-relief format could be rated under its 'Global Structured Finance Rating Criteria'. Depending on the available enhancement, Fitch would recognise this via a recovery uplift of up to two notches above the bank's IDR, if it is in the investment grade range. DBRS also said it could rate both structures, but the methodology would depend on the structure detail, legal framework, collateral information and transparency and provision (or not) of guarantee.

■ **Would investors buy ESNs?** ESN could appeal to investors while covered bond yields are low. We ran a survey among real money investors to gauge investor sentiment on this product. Although some investors were hesitant to participate before more clarity is given on the product, we were able to gather a representative sample of responses. In terms of product design, respondents have a **preference for the on-balance sheet ESN structure** over the off-balance sheet structure. Homogeneous, easily comparable pools should be an essential feature of this product. Those investors preferring the off-balance sheet ESN said an external guarantee would not be necessary. **Preferential regulatory treatment** is crucial for the development of the product and **regulation enshrined in law** (at EU level) is preferred over contractual features. Other key factors in the investment decision will be **liquidity, index inclusion** and to a lesser extent rating. With regards to **pricing considerations**, a key driver for demand will be where the product will be placed between covered bonds and other asset classes.

Table of contents:

*Key points 1*

*European Secured Note: what is it? 2*

*ESN proposed structures 3*

*Key takeaways from ESN*

*Investor Survey 4*

## European Secured Note: what is it?

The ECBC proposes to analyse the potential of a dual recourse funding instrument to respond to several priorities foreseen in the Green Paper namely (i) widening the investor base for SMEs and (ii) building sustainable high-quality securitisation.

ECBC proposes two potential structures for the ESN ...

...an on-balance sheet ESN (for funding purposes)

...and an off-balance sheet ESN (for capital relief purposes)

While the ECBC proposal is broad in its comment and scope, it proposed two potential instruments aimed at improving the long-term funding for non-traditional collaterals such as SME or infrastructure loans:

- **On-balance sheet ESN (for funding purposes):** dual-recourse instrument using funding techniques derived from those used for covered bonds. As the name suggests, it is an on-balance sheet, dual-recourse obligation (benefiting from both the value of the collateral pool and a guarantee from the originator), backed by a dynamic pool of underlying obligations, and strengthened by a legal framework. For the on-balance sheet ESN to work, two elements are necessary: (i) a robust legal framework and (ii) a sufficiently high level of transparency regarding the asset pool.
- **Off-balance sheet ESN (for capital relief purposes):** are referred to as an instrument offering a degree of capital relief to the issuer through risk-transfer, whilst offering investors a more interesting yield proposition than the on-balance sheet alternative. The ECBC proposes that the static pool of SME assets be transferred to an off-balance sheet vehicle, where risk would be tranching and offered to investors. Public bodies could play a role in either investing or guaranteeing more subordinated risk positions. The equity tranche could be guaranteed by institutions such as the European Investment Bank Group (in particular the European Investment Fund), while the mezzanine tranche could be guaranteed by government-owned development banks (e.g. KfW, CDP, ICO, CDC) to encourage public involvement and the sponsoring of securitisation as a means of financing the real economy. Whilst senior notes would also be guaranteed by the originator. **This structure would closely resemble a securitisation** in the sense that the assets used in the pool would be transferred to an SPV via true sale or pledging using, for example, the collateral directive. As with traditional securitisation, the security would be tranching and each tranche would be secured by a portfolio of SME claims. Two basic general principles would need to be satisfied: 1) the originator must comply with the retention requirements by either retaining the junior tranche, 5% of each tranche, or by a 5% portfolio of similar risk on its balance sheet; and 2) public/international sponsors could play a role in investing or in guaranteeing some of the riskier tranches.

Clear demarcation between traditional covered bonds and European Secured Note

The ECBC notes that the ESN tool should be based on common eligibility criteria, definitions, risk parameters, data disclosure and IT solutions across European countries. The ECBC however, is clear in highlighting that traditional covered bonds have very precise quality features recognised in regulation and should not be watered down. They highlight authorities would need to establish a clear demarcation line between the traditional covered bond space and the potential use of dual recourse techniques for other kinds of assets as collateral.

**In our view, the public supervision of this product, together with UCITS eligibility, will be crucial for market acceptability as it would pave the way for favourable regulatory treatment (e.g. eligibility for LCR purposes, Solvency II, ECB and Bank of England repo, CRA III Regulation).**

## ESN proposed structures

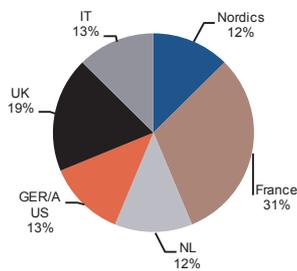
The ECBC proposes five possible structures for the on-balance sheet ESN and two possible structures for the capital relief ESN.

1. **Classic Direct On-Balance Issuance** (structure used for CBs in Germany, Spain, Denmark, Cyprus and Belgium), where the issuer of the bond is a bank and investors have a dual recourse to a bank and a segregated pool of assets. The assets are segregated through a pledge/register/specialised banking. Investors have a preferential claim to the segregated assets in the event of insolvency of the issuer. A potential disadvantage could be that the segregation of assets and swaps on-balance sheet may not be possible in certain jurisdictions due to the current legal setup.
2. **On-Balance Sheet Issuance with Separate Guarantor** (structure used for CBs in Italy, the Netherlands, the UK, Canada, NZ, Australia). In this structure, the bonds are issued by the bank whilst the assets are transferred to a separate legal entity that guarantees the bonds used. In this case, the legal framework should 1) allow the transfer of assets via true sale and 2) address potential limits on intra-company exposure. The guarantee provided by the SPV implies dual recourse.
3. **Issuance by SPV with True Sale of Assets from Bank** (similar to German 'Refinanzierungsregister' or Danish 'Corporate Loan Refinancing Register'). The bank maintains the assets in a dynamic register but the segregated assets are truly sold to the SPV (dual recourse with assets no longer bail-in-able). The structure requires clear segregation of assets and debtors' set-off rights need to be addressed in the event of the bank's default.
4. **Issuance by SPV with Guarantee from Bank:** bonds are issued by the SPV that holds the assets (true sale). The bank is providing a guarantee on the bonds: there is no automatic dual recourse and most servicing activities are outsourced by the SPV to the bank.
5. **Multiple Bank Funding Structure:** bonds (or certificates) are issued by a bank or SPV in which the assets have been segregated via the registering of the assets in other entities. Issues about the transparency on all underlying assets and the bail-in topic should be addressed by the legal framework.
6. **ABS Guaranteed:** bonds are issued by the SPV according to the traditional securitisation structure with a first demand guarantee released by a supranational Guarantor on senior notes. Limited changes to the regulatory framework would be required but few guarantors would meet the criteria.
7. **ABS Backed by a Limited Recourse Loan:** bonds are issued by the SPV while the portfolio remains in the originator book. Pervasive changes to the legal framework are required in order to ensure the assets' segregation and the proper functioning of the structure.

## Key takeaways from ESN Investor Survey

Of the two main ESN proposals, most investors would prefer the on-balance sheet structure. Preferential regulatory treatment is crucial for the development of the product and regulation enshrined in law (at EU level) is preferred over contractual features. Other key factors in the investment decision will be liquidity, index inclusion and to a lesser extent rating. What is clear is that investors will require granular, transparent, easily identifiable pools. The ESN is viewed as a credit product and investors agreed in terms of relative value, they would price the on-balance sheet ESN somewhere between traditional covered bonds and senior unsecured notes.

Investor sample distribution by region



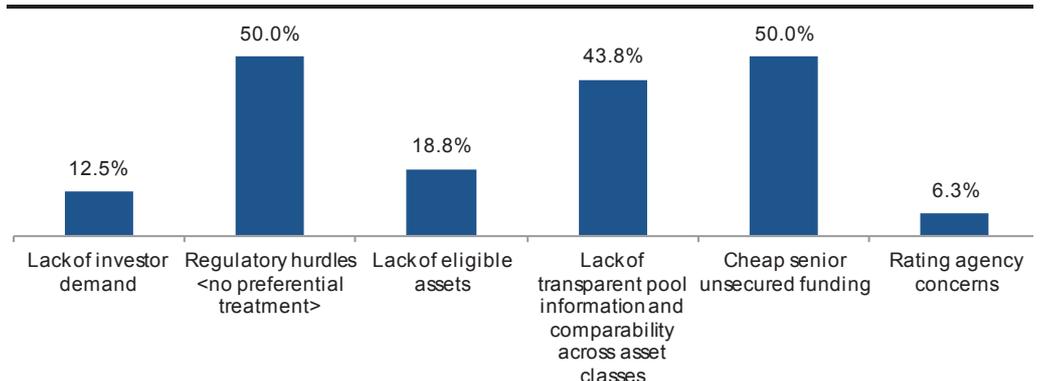
Source: SG Cross Asset Research/Rates

In view of the upcoming ECBC Covered Bond & European Secured Note Roundtable to be held on 8 and 9 October in Milan, we conducted an investor survey over the past weeks to gauge investor sentiment on the ECBC's European Secured Note (ESN) proposals. The questionnaire included 11 questions and was aimed at understanding which structure would be preferred, and which common criteria and features would be necessary to attract demand. We targeted real money investors, with 75% of respondents being asset managers. We specifically did not target many bank investors, because the large majority require regulatory treatment (LCR eligibility, preferential risk weighting) as sine qua non conditions to consider such a new product. Instead, we focussed on large asset managers who would have a more open approach to new dual recourse instruments, rather than pure traditional covered bond investors. This explains the relatively low participation of German investors. Although small (16 respondents), our sample is representative given that **the investors that took part in our survey represent approximately €5 trillion AUM.**

### Lesson no. 1: Cheap funding and regulatory hurdles cited as the main reasons for low supply of dual-recourse instruments

Cheap senior unsecured funding and regulatory hurdles are cited as the main reasons for low supply of dual-recourse instruments. **Lack of transparent pool information and comparability across asset classes was also cited as an important factor.** Other reasons cited were the cost as well as the availability of overall cheap liquidity in the market. For issuers, the relative value of such a trade, when they could alternatively access TLTRO funding or ECB funding, issue covered bonds and cover the remainder of the balance sheet with deposits, means interest would be limited, especially whilst the ECB's QE programme is running. Interestingly, both lack of investor demand and rating agency concerns were not seen as main concerns.

In your opinion, what have been the reasons for relatively low supply of dual-recourse instruments?

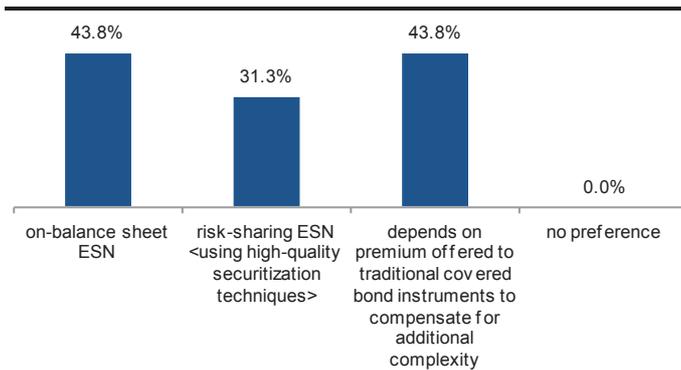


Source: SG Cross Asset Research/Rates

*Lesson no. 2: Most investors seem to prefer the on-balance sheet ESN, with granular transparent collateral*

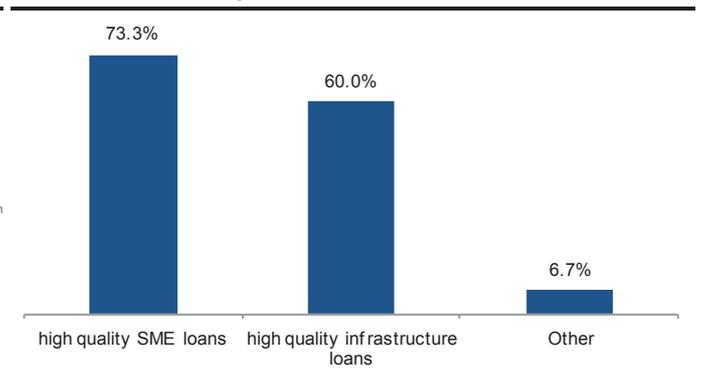
With regards to product design, most of the respondents seem to favour **the on-balance sheet ESN** structure over the risk-sharing ESN format. However, many investors pointed out **that the choice of structure would ultimately depend on the premium offered to traditional covered bond instruments to compensate for the additional complexity**. For many investors, the capital-relief ESN structure very closely resembles securitisation, and, if faced with a choice between both, they would choose the securitisation route. For many, ABS enables in the best possible way investors to choose a risk return profile based on specific collateral pool via the tranching of the notes and the issuer can choose between a simple financing trade or a capital relief trade by deciding which part of the structure he wants to place with external investors. Ultimately, if regulators were to rethink their approach to penalising European ABS, the off balance sheet, capital-relief ESN initiative could become obsolete.

Which ESN structure would you prefer?



Source: SG Cross Asset Research/Rates

To consider ESNs which type of collateral would you be interested in investing in?



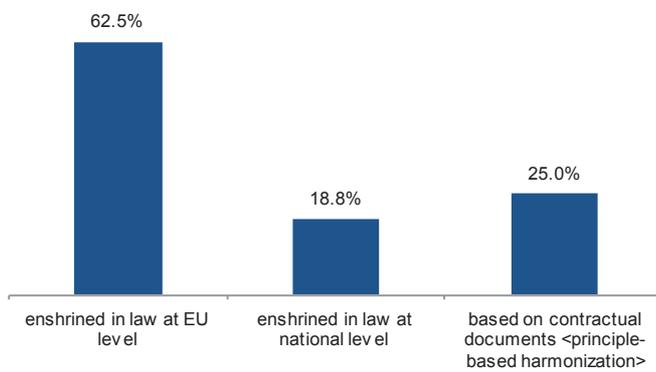
Source: SG Cross Asset Research/Rates

In terms of collateral, **investors seemed to have a preference for high quality SME loans**, although infrastructure loans were also high on the list, **as long as they are high quality, granular and easily identifiable, comparable pools**.

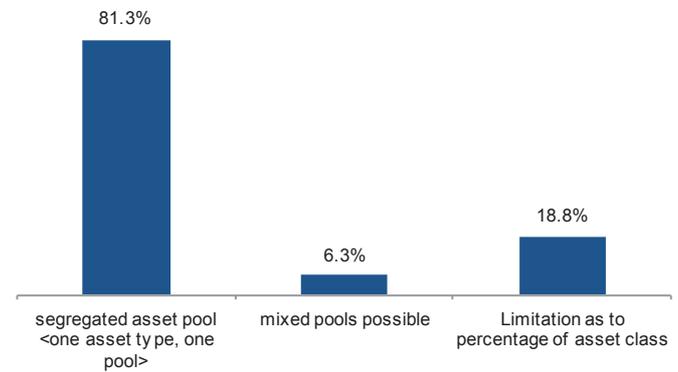
*Lesson no. 3: Regulation preferred over contractual features*

Investors have a clear preference for the **European Secured Note product to be enshrined in law, rather than based on contractual features**. The overwhelming majority prefer regulation at EU level, rather than at national level. **Furthermore, investors prefer easy to analyse, granular segregated pools**. As such, the majority of respondents prefer homogenized cover pools (one asset type, one pool), with some investors asking for a limit per asset class to be defined.

To ensure recognition, marketability and liquidity of this instrument, collateral eligibility criteria should be developed. **Where/How should the eligibility criteria be developed?** The eligibility criteria of collateral backing ESNs would need to be clearly defined, to ensure high-quality instruments. **Would you require the collateral pool to be:**



Source: SG Cross Asset Research/Rates

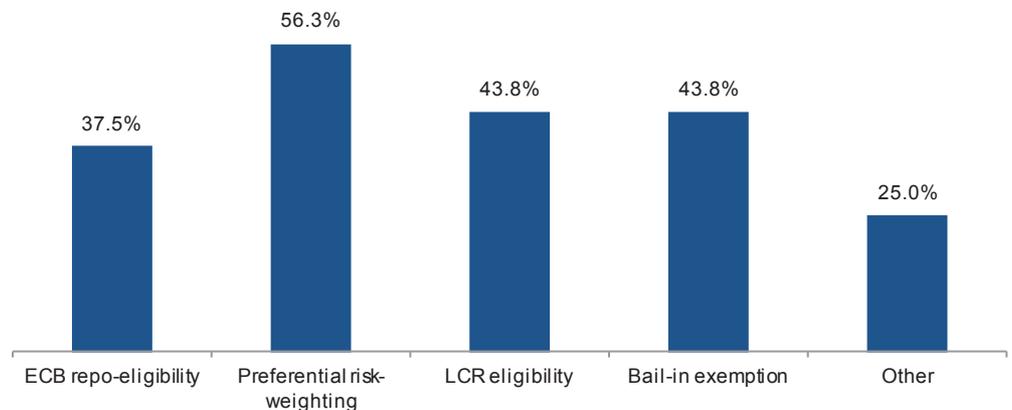


Source: SG Cross Asset Research/Rates

*Lesson no. 4: Preferential regulatory treatment crucial for development of the ESN product*

We targeted our survey mainly at real money investors and refrained from contacting many bank treasuries as for them, the sine qua non condition is preferential treatment (ECB repo-eligibility, LCR eligibility). What was interesting to note, was that with a large proportion of asset managers in our sample, **most cited preferential risk-weighting, LCR eligibility and bail-in exemption as important features the ESN instrument would need to have**. Other factors mentioned were index inclusion and rating. Liquidity is also key, as the ESN would need to be a sellable product.

**Key factors, from a regulatory perspective, necessary for ESN development**

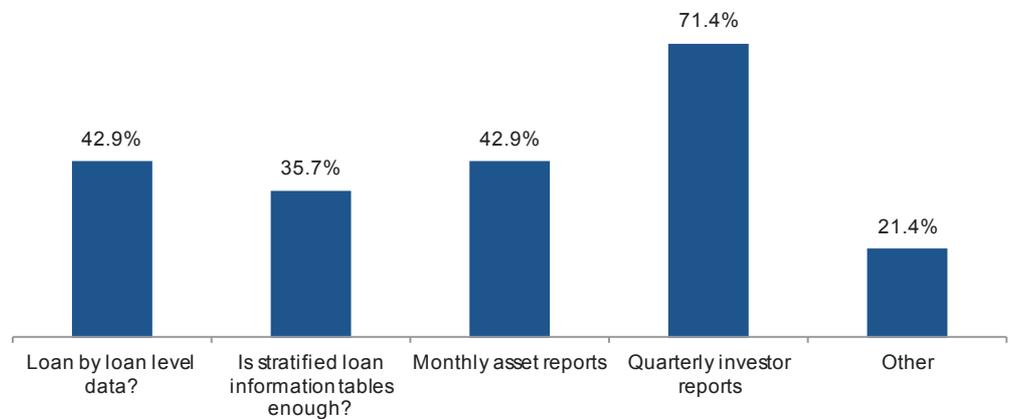


Source: SG Cross Asset Research/Rates

*Lesson no. 5: Granular, comparable, easily identifiable pools required*

It is crucial to guarantee homogeneous and comparable characteristics, in order to facilitate lenders' and investors' due diligence and create the preconditions for a future pan-European cross-border SME financing landscape. Investors agree that for ESN product to take off, the collateral needs to be defined in terms of clear, key risk parameters. Regular, easily comparable investor reports are required. In terms of frequency, quarterly reports are the minimum but monthly asset reports would be privileged to monitor the dynamic nature of the cover pool. Respondents mentioned the availability of loan-by-loan level as helpful in their analysis, although stratified loan information tables would be enough.

**For ESNs to gain market traction, the market would require harmonized levels of information and reporting to facilitate monitoring procedures and pricing rational. Would you require:**



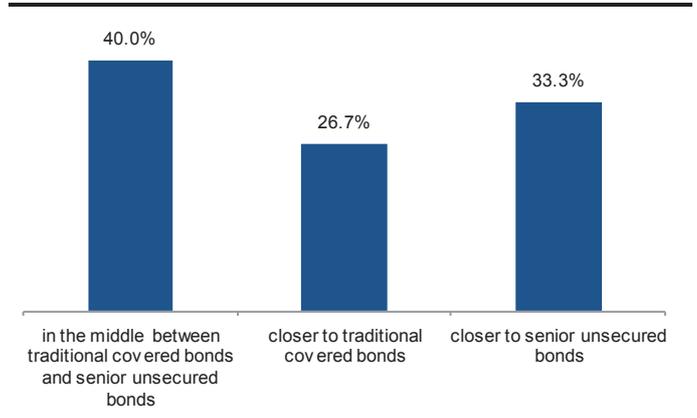
Source: SG Cross Asset Research/Rates

The underlying loans (SMEs, infrastructure) are a more complex asset class and there is no common information on credit history and performance. As such, before the ESN initiatives come to fruition, investors highlighted the importance of having a centralised platform on which all data is uploaded and stressed the need for all pool information to be made public without restrictions on any institutional investor to access the data and reports.

*Lesson no. 6: Relative value and liquidity of the product cited as the main investment drivers*

As we mentioned earlier, liquidity in the secondary market will be a key driver for investors. **For the on-balance sheet ESN, a key driver for demand will be where the product will be placed between covered bonds and senior unsecured bonds.** When considering pricing, the responses were more muted with a slight preference for spreads to be closer to senior unsecured bonds, rather than closer to traditional covered bonds.

Where would you position the on-balance sheet ESN on the spread scale between levels of traditional CBs and SUR bonds of the same issuer/originator?

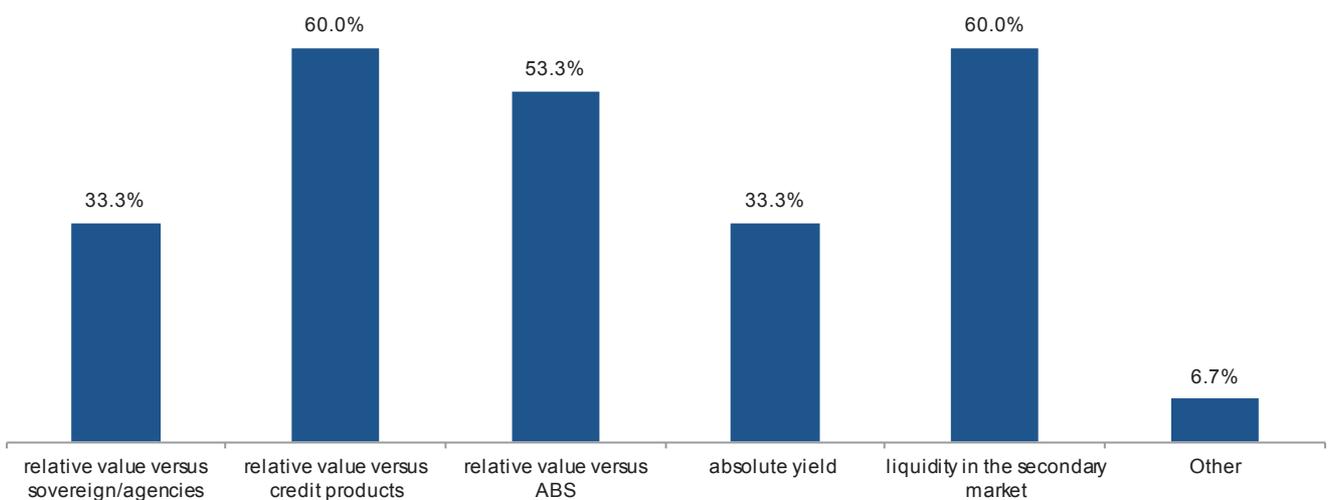


Source: SG Cross Asset Research/Rates

But the pricing will ultimately depend on the quality and recovery expectation of the underlying collateral pool. If the ESN product is bail-in exempt, the product would be positioned closer to traditional covered bonds.

**For the off-balance sheet, capital relief structure, the relative value of the product in relation to ABS will be a main investment driver.** Absolute yield was also cited as a key determinant, particularly in the current low yield environment.

From a market perspective, what would be the main driver(s) to invest in this product?



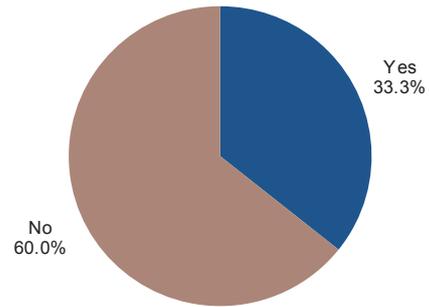
Source: SG Cross Asset Research/Rates

*Lesson no. 7: external guarantee not necessary for development of capital-relief ESN*

In the off-balance sheet, capital relief ESN structure, the ECBC proposes that public bodies could play a role in either investing or guaranteeing more subordinated risk positions.

For risk sharing ESN, the junior and equity tranches could be guaranteed by institutions (EIB and the European Investment Fund, KfW, CDP, ICO, CDC) to encourage public involvement and sponsoring of securitisation. However, when asked, **most investors said an external guarantee is not necessary for the development of a capital-relief ESN.**

**For capital relief ESN, should the junior and equity tranches be guaranteed to external institutions?**



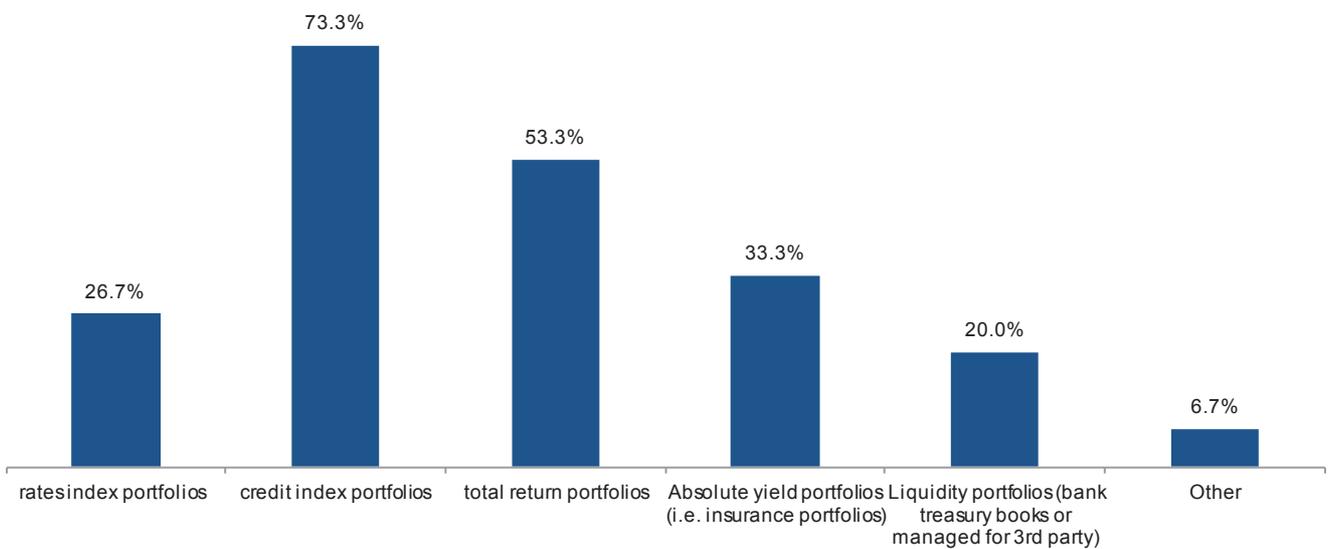
Source: SG Cross Asset Research/Rates

Nevertheless, although not a necessary condition, many respondents cited the product would be enhanced with a guarantee.

*Which investors would potentially buy European Secured Notes?*

As can be seen in the chart below, the ESN product is seen as a credit product, with most portfolio managers saying that if this product were to be developed, they would go into credit index portfolios. The product would be interesting for total return portfolios and, less so for absolute yield portfolios or rates index portfolios. As was to be expected, few respondents mentioned the liquidity portfolios – this will depend on what regulatory treatment the instrument receives.

**Within your institution, which PMs would potentially buy ESNs?**



Source: SG Cross Asset Research/Rates



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## APPENDIX

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#### **Individual Bond recommendations:**

**BUY:** Indicates likely to outperform its iBoxx subsector by 5% or more

**HOLD:** Indicates likely to be within 5% of the performance of its iBoxx subsector

**SELL:** Indicates likely to underperform its iBoxx subsector by 5% or more

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SG Credit research evaluates its expectation of how the 5 year CDS is going to perform vis-à-vis its sector.

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**NEUTRAL:** CDS spreads should perform in line with its iTraxx sector performance

**BUY:** CDS spreads should underperform its iTraxx sector performance

#### **Sector weightings:**

**OVERWEIGHT:** Sector spread should outperform its iBoxx corporate index

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Bank

European Investment Bank SG acted as a co-lead manager in EIB's bond issue TAP (2018)  
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Bank

KFW SG acted as co-lead manager in KFW's bond issue (USD, 3yr).

KFW SG acted as a member of the selling group for KFW's bond issue (3yr)

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