European Mortgage Federation - European Covered Bond Council (EMF-ECBC)

European Secured Notes (ESN) Blueprint

Introduction

1. The European Policy Agenda

In the context of the Capital Markets Union debate, building on the success of covered bonds, the EMF-ECBC promoted the ESN-initiative as a dual-recourse long-term funding instrument to allow for the financing of new asset classes beyond the traditional covered bond collateral types, such as SME loans and green, social and infrastructure assets. This initiative combines existing covered bond techniques and best market practices for the establishment of a funding solution for lenders and a new product for institutional investors, which would also be accessible in a stress scenario acting as an anti-cyclical funding tool providing support for the real economy.

This project has gained even more importance due to both the launch of the European Commission's new Action Plan on the Capital Markets Union and to the possible use of ESN as a recovery tool from the COVID-19 pandemic. There is clearly an urgent need for a comprehensive, coordinated European response to the economic impact it has had, especially on the small and medium sized enterprises (SMEs) on which the European economy depends so heavily.

Against this background, also considering that according to the provisions of the Covered Bond Directive the European Commission (EC) has to write a report on ESN and may propose a legislative initiative, the ECBC has resumed the work of its ESN Task Force (TF) inviting both its members as well as important stakeholders such as the European Bank of Reconstruction and Development (EBRD), the European Investment Bank (EIB) and a wide array of interested parties such as investors, issuers, rating agencies and business associations. The goal is to share intelligence and knowledge via different work-streams by defining concrete proposals, providing technical advice, investor education and sharing best practices between the members from the various jurisdictions. The EC will ultimately receive the technical analysis and recommendations of the ESN Task Force.

The European Banking Authority shared the view in its Report on the European Secured Notes published on 24 July 2018 that ESNs might provide a useful additional source of funding for SMEs, especially for small institutions that do not have access to the securitisation market and/or have difficulty issuing unsecured long-term debt. The TF is also aware of other available research such as the Study on the Feasibility of European Secured Notes prepared by Richard Kemmish Consulting and published by the European Commission in July 2018.

2. Considerations on Data Disclosure and ESG

The current policy framework sees on the one hand the European Green Deal scaling up the sustainability ambition of the continent coupled with the ongoing Taxonomy discussion and at the same time the COVID-19 pandemic which has put in jeopardy a significant share of households and SMEs. Against this background a project such as the ESN is perfectly suited to intercept these ambitions and needs in positioning its focus not only as funding instrument for SMEs, but playing a significant role in connecting both the demand of the real economy to support their recovery and their commitments to sustainable improvements as well as the demand of the financial industry to delivering an SME funding tool including ESG considerations.

The ESG dimension in the discussions on the ESN is a necessary strategic step to take in order for this nascent asset class to be relevant in the future. In order to be operational it is important to highlight the current lack of a standardised and transparent disclosure of ESG data by the SMEs, which can lead to contrasting judgements on the ESG-alignment of the same firm by different financial actors and generate information asymmetries thus hampering risk assessment and decarbonisation.

Moreover, ESG information is available only for large and listed companies whereas the ESG reporting landscape from SMEs is at best ad hoc. A further barrier is represented by the lack of standardised disclosure of SME energy efficient investments and ESG performance. The need of information proper disclosure has also been highlighted by the European Commission (EC) with the recent proposal of the ESAP initiative in the context of the Capital Markets Union Action Plan. ESAP (European Single Access Point for financial and non-financial information) is conceived as a platform to collect all relevant and publicly-disclosed corporate information–including sustainability-related information, to facilitate investors' access to company information and companies' access to financial markets. The ESN initiative seems compatible and perfectly fit with such an exercise proposed by the EC.

SMEs play a crucial role in the EU economy, representing more than 95% of all businesses, around 85% of new jobs and two-thirds of the total private sector employment before the COVID-19 crisis. Nevertheless, information regarding the SMEs' energy efficient investment performance is still poor. The EU Taxonomy represents a useful tool to assess and classify the sustainability of an economic activity, however this process will take some time and initial hurdles must be overcome (for instance, at present it does not cover the whole range of economic activities and it does not result straight forward to be applied to all SMEs).

With these barriers in mind the ESN project would benefit from considering setting up a harmonised data template to collect information on the funded SMEs, leaning on the positive experience from the Harmonised Transparency Template of the Covered Bond Label, which after 8 years since inception is now used for reporting the underlying cover pool assets of over 70% of the covered bonds outstanding globally and where in 2020 a new ESG specific section has been included in the template. This already functioning best practice would act as blueprint for the ESN TF to set up similarly a harmonised template for SME data with a dedicated ESG section, in collaboration with the investor community in order to intercept the relevant data points necessary to assess the ESG exposure and the creditworthiness of SME loans in the ESN cover pools.

Well knowing that the work on developing a shared framework for ESN has just begun, this Note would like to present a first outcome of the work of the TF highlighting in this context both the points where a common understanding was achieved among participants and stakeholders, as well as where further discussion, research and exchange of views are necessary. A comprehensive questionnaire prepared the ground for the views expressed hereafter (see Appendix 1 for full ESN questionnaire). The Note is divided into the following three chapters:

- The Business Case
- Eligibility Criteria
- Analysis of Structural Features

The Business Case for ESN

The TF has been focusing on the rational/business case behind the need for the introduction of ESNs.

1. ESN as a Funding Tool for SME

Further to a recent survey and discussions among TF members, it was agreed that ESNs should be a pure dual recourse funding tool that is compatible with but independent from other tools which can address the capital consumption of the underlying assets. Furthermore, the majority of members to the TF agreed to focus on SME financing rather than infrastructure. Discussions are ongoing whether to also include larger enterprises. In general terms, building a new market segment requires critical mass and a certain amount of homogeneity. There have been attempts in issuing SME backed covered bonds more than a decade ago but which were not replicated significantly since then. Today, the situation is different to the extent that SME lending is more relevant than ever and a decisive component for the European recovery, tightly linked to employment and sustainability concerns.

According to 2017 Eurostat figures (most recent figures available), European SMEs employed 83.9 million people in total and produced EUR 3 467 billion of value added or 56.4% of the overall economic contribution in the EU. In contrast, just 0.2% of all enterprises had 250 or more persons employed and were therefore classified as large enterprises. As regards the SME market structure, the overwhelming majority (almost 90%) of enterprises in the European Union's non-financial businesses were micro-enterprises, i.e. SMEs with less than 10 persons employed. This provides evidence to assume that SME loans eligible for ESN funding might be composed to a large extent of exposures to micro-businesses.

It is challenging at this stage to assess the potential size of an ESN market but the SME loan market of the European Union amounting to EUR 3.3 trillion (as of June 2020) reveals substantial. Regular research confirms that bank-related finance still represents the most important financing channel for SME's in the European Union. In this context, ESNs could efficiently complement deposits and the issuance of unsecured debt as an additional funding tool for SME finance.

Intuitively, three main elements for ESN can be identified. 1. The historical risk cost of SMEs 2. Potential mitigating factors like guarantees of institutions like EIB. 3. Policy settings in that the ESN would provide policymakers with a tool to specifically support SMEs in a targeted manner (ideally in sustainable format, see below). The combination of the three factors would provide an asset class serving the specific purpose to support SMEs and employment, therefore enjoying policy support which in turn reduces the risk cost to issuers and potential ESN investors.

ESN collateral should be made up by SME loans mainly (including SME loans that are guaranteed by national or supranational entities), to maintain a greater degree of homogeneity and ensure a sufficient level of granularity. A large base of eligible SME assets, including secured and unsecured SME loans, as collateral is recommended for the following reasons: (i) it will offset amortisation since SME portfolios have relatively short lives and this will allow issuers to maintain overcollateralization levels without the risk of running out of assets, (ii) the level of delinquent and defaulting SME loans is greater than that of residential real estate loans and issuers will need a large base of collateral to compensate, and (iii) outstanding SME loan volumes can be much lower than mortgage loan volumes in some jurisdictions. Broadly speaking, the criteria for determining eligible SME loans should also be construed such that they don't restrict banks under the standardised approach to gain access to this funding tool.

2. ESN as an Alternative Investment for Investors

It can be expected that the investor base for ESNs will be similar to the covered bond one. Similarly, rating agencies have indicated they will apply their covered bond rating methodologies to rate ESNs if structured as a dual recourse funding instrument. Hence, it can be assumed that investors looking for a dual recourse instrument will be using the pricing of covered bonds as the starting point to determine the pricing for ESNs.

At present, it is particularly challenging to assess the risk profile of ESNs from an investors' perspective. Asset and capital market performances of ESNs are strongly correlated with their collateral risk profile, i.e. depend on the credit quality of the underlying exposures and the robustness of cover pools as a function of the selected cover pool eligibility criteria. Of course, other features such as asset segregation, public supervision and other structural elements will contribute to the overall soundness of the instrument also from an investor perspective.

ESNs will probably require a higher yield for investors due to different perceived credit quality, different prudential treatment (see below), investment mandates, liquidity and specific structural features. Given the higher cost of risk and higher margins in the SME sector, ESNs could be an attractive investment tool for investors seeking to take exposure in the European post COVID-19 recovery. ESNs could provide a more attractive investment alternative to traditional asset covered bonds in the event of significant concerns regarding concentration risk. Indeed, investors might more strongly differentiate between issuers / asset classes / cover pools / countries.

ESNs, as a dual recourse instrument, when compared to similar maturities, should price tighter than a securitisation but at the same time wider than traditional mortgage covered bond. Overall, ESNs are expected to offer a pick up versus traditional mortgage covered bonds but should provide a funding advantage with respect to unsecured funding. ESNs would benefit from the interest of covered bond investors, such as pension funds and institutional investors, who may have been crowded-out by the monetary policies enacted during the crisis. Such investors with a higher risk appetite than traditional covered bonds are seeking higher yields. Finally, the perspective for a favourable regulatory treatment of ESNs and their potential role in sustainable recovery will also attract traditional covered bond investors.

In comparison to the SME securitisation, ESN should be more cost-efficient tool for the issuers and more liquid instrument for the investors with expected better regulatory treatment. SME securitisations, being stand-alone transactions, are generally costly and cumbersome to execute and it only makes sense if you tap the markets with large amounts in order to reduce structuring costs. Not only large banks, but also medium size, regional banks would benefit from setting up an ESN programme in that it would allow them to tap the markets regularly, also with smaller tickets, since issuance costs would be just a fraction of initial set-up costs.

Buyers currently choose covered bonds mainly for (i) regulatory reasons (LCR etc), (ii) secondary market performance (given ECB purchasing), (iii) to meet index requirements and (iv) for the diversification properties. Potentially, some structural differences between ESNs and traditional covered bonds could be perceived as favourable to the former. For example, ESNs could address investment needs in the more intermediate part of the maturity curve which corresponds to the typical funding needs of SMEs. It is worth noting that the large majority of outstanding covered bonds currently have a negative yield. The ESN in this respect would provide a valuable alternative investment.

3. ESN as a Funding Tool for Sustainable Recovery

In addition to the potential role of ESNs in the aftermath of the COVID-19 pandemic and related ESG considerations described in the introduction above, it is worth underlining that the need to support SMEs in terms of liquidity and capital is likely to increase further. This is even more valid as SMEs historically face major obstacles to access capital markets, not least because of the structure of the European SME market largely composed of micro-enterprises.

In addition, ESN may be seen as a private sector solution for the recovery, when the depletion of public funds and programmes will decrease and ultimately come to an end. In such a context, ESN offer an exit strategy in the recovery phase.

Policymakers and banks will, therefore, have to find tools to provide viable businesses with capital and liquidity and investors see the potential for ESNs to solve this and increase access to capital for SMEs which will in turn support employment and sustainable economic recovery. For this reason, the potential of ESNs to be linked to sustainability, employment and social requirements needs to be further addressed, all the more since evidence about the type of responsible and sustainable activities of small enterprises and available sustainability management capacities have considerable room to increase. Once sustainability criteria are systematically embedded into regulation, SMEs could earn an appropriate treatment for ESG assets.

Finally, after the return of the ECB to a more traditional toolbox and the termination of the funding facilities currently provided to fund SMEs (TLTROs), ESN should be part of the ECB's future toolbox given the link to sustainability and, in that context, continue to benefit from ECB support (similar to corporate bonds).

4. Preferential Regulatory Treatment of ESNs:

In order to stimulate the market appetite and improve the efficiency of ESNs, it is crucial to consider what regulatory treatment the ESN is likely to receive and which aspects are the most relevant. The three most important 'regulatory' aspects of the treatment of ESNs that could be provided are i) the non bail-in-ability treatment, ii) the eligibility under ECB rules for use as repo collateral and under purchase programmes and iii) a high standard of eligibility under the rules for HQLA (for purposes of LCR ratios) for bank treasury purposes.

Whereas the bail-in exemption should be available on the basis that ESNs take the form of a dual-recourse instrument, LCR eligibility in particular will require further assessments as regards, inter alia, high credit standards, cover pool safety features (credit enhancement), secondary market liquidity and the consistency of the regulatory framework for the asset class. ECB eligibility is fundamental and based on the previous attempts in the EU in issuing SME backed covered bond, such eligibility should not be impossible to achieve.

Market participants have also indicated as important a number of other forms of prudential treatment, such as risk weights for bank (CRR) or insurance (Solvency II) investors or UCITS fund concentration limit exemptions, and exemption for ESN issuers from clearing and posting margin to allow potential hedge of interest rate and currency mismatches using swaps (EMIR treatment). Finally, the preferential regulatory treatment may vary according to the assets and the eligibility criteria of the assets that will be included in the cover pool.

Regulatory and prudential treatment of ESNs should take into consideration a number of factors that investors have deemed important when comparing ESN to other traditional instruments. These are (i) the probability of default or loss given default of SME assets which will determine the cost of risk, (ii) risk mitigation and potential guarantees by SSAs and European Institutions (such as EIB and EBRD) and (iii) potentially the link of ESNs to sustainability and social purposes. The evaluation of these factors will depend and must take care of the availability, accessibility, consistency and quality of the loan level data across jurisdictions. An update of the issuers' preferences and a possible involvement of investors could also be foreseen.

As a final remark, the introduction of ESN could be complementary to the introduction of covered bonds in certain EU jurisdictions. Being a similar technique to build up funding programmes (asset segregation, public supervision, overcollateralization and transparency requirements), a parallel introduction of the two financial instruments could facilitate the expansion of capital markets using different assets classes as collateral (i.e. mortgages and public assets for CB and SME loans for ESN). In some cases the role of the EBRD would be very useful to this respect.

5. Capital relief features: a possible add-on to ESN

To recall, the possibility of using ESN as a capital relief instrument (with some features akin to securitisation) was explored when the ESN project was launched in the wake of the Capital Markets Union. Such structures, though theoretically possible, are overly complicated and since then, the focus has remained on the funding role of ESN and such more complicated structures achieving capital relief were considered out of scope by the TF.

However, the Task Force does believe that the ESNs, though a pure funding instrument, can be structured with add-on features in such a way that, their risk profile ~~is~~ could also be compatible with [unlinked] synthetic risk transfer solutions, without changing the dual recourse basic structure of the product. A way in which ESNs could be made compatible with [unlinked] synthetic securitisations would be for the asset eligibility criteria for the ESN assets to be aligned with, for example, minimum standards defined by the EIB for their synthetic securitisation programmes.

Such features may result particularly useful in a recovery context where banks in addition to funding purposes, may also have the need to free-up capital in order to provide new lending to the economy. These structures may be explored further also with supranational entities specialised in the risk sharing of SME portfolios. As this feature to free-up capital is a mere add-on to the main ESN concept as funding tool, this note will not focus on such possibility, leaving it, if the case may be, to the specific portfolios and objectives of prospective ESN issuers.

Conclusions:

The TF believes there is a business case for the ESN to be further explored at the appropriate levels and with the relevant stakeholders.

Next Steps:

- Discussion on the regulatory treatment for ESN.
- Update of the issuers' preferences.
- Collect feedback from investors and mapping their needs.
- Assessment of the role for ESN in sustainable growth.

ESN Cover Pool Eligibility Criteria

It is suggested to focus the scope of ESNs at this early stage on the funding of SME exposures. Besides SME lending, longer term infrastructure finance might be another very relevant field for the real economy and sustainable developments. Infrastructure loans typically also feature public sector involvement and this field is expected to be a post-pandemic fiscal priority. In terms of urgency for the European recovery, lending to SMEs is certainly the priority as regular financing needs of SMEs and infrastructure finance (as observed in project finance) widely differ. In terms of positioning, in order to introduce infrastructure ESNs, more work would need to be done to distinguish them from public sector covered bonds more clearly and to evaluate the business potential versus one another.

1. Definition of SME

There are currently different definitions of SMEs at EU level. In order to harmonise these definitions, the CMU Action Plan *published on 24 September* 2020 announced the intention to find a uniform SME definition in EU law. More precisely, it was announced that the European Commission will assess the appropriateness and consistency of the SME definition across financial legislation in order to promote and diversify small and innovative companies (see *Action 2: Supporting access to public markets - expected delivery by Q4 2021).*

At present, the most appropriate approach is provided by Article 501 (2) of the CRR and the Commission's recommendation 2003/361/EC of 6 May 2003, where a SME is defined as follows:

- a business employing a maximum of 250 employees and
- which has an annual turnover not exceeding EUR 50 million and/or
- an annual balance sheet total not exceeding EUR 43 million.

The TF discussed the appropriateness of the number of employees as eligibility criteria for ESNs. It shared the view that the number of employees doesn't necessarily appear as a valid indicator for the economic size of an enterprise. Because of the specific purpose of ESNs, the framework should not exclude work-intensive businesses with workforces beyond the threshold whilst presenting a moderate balance sheet total or a moderate turnover level. Such SMEs might be innovative and provide valuable jobs to the local economy.

In the same line of thinking, SMEs should be both legal corporations and individual entrepreneurs (natural persons). In a number of Member States individual entrepreneurs represent a considerable portion of the SME sector and such entrepreneurs mainly rely on bank funding.

Furthermore, specificities of legal and fiscal regimes of Member States might require additional room for manoeuvre. In cases where collateralized loans are provided to SMEs, a separation between ownership companies (special purpose company holding the collateral) and the operating SME might be processed. Whilst the loan is granted to the ownership company, a look-through approach to the operating SME should apply.

In conclusion, the TF recommends that the definition of SME for ESN eligibility purposes should be covering the following criteria:

SME-entities are businesses

- *which have an annual turnover not exceeding EUR 50 million and/or*
- *an annual balance sheet total not exceeding EUR 43 million*

at the time of inclusion into the cover pool.

For the sake of portfolio stability it is advisable that the SME eligibility criterion is proved only at inception, i.e. when the asset is included in the cover pool. The possibility of the SMEs growing out of the thresholds and the cover pool therefore becoming less granular could be compensated by an exposure[1] cap of 2.5 Mio EUR (in accordance to the limit of the SME-Supporting-Factor in Art. 501 CRR as amended in 2019) or as a proportion of the cover pool.

Further adaptations of the SME or enterprise criterion might reveal necessary in due course. The TF considered it worthwhile to exploring the possibility to also include in ESN cover pools exposures to SMEs with a turnover in excess of EUR 50 million. There are good reasons to argue that a successful ESN funding tool shall eventually be available to all corporate structures, i.e. also to larger companies in order to cater for the different specificities of national economies.

2. Eligible Assets

The TF shares the view that ESN cover assets should consist of exposures to SMEs. With regard to the different corporate structures, the variety of financial products and methods of financing applied across the European Union, it was considered inappropriate to further define exposure types at European level. Although materialising in the vast majority of cases in credit or loan facilities, the exposure term covers all risk positions of a financial institution towards the borrowing entity. It would be the duty of Member States transposing the ESN framework into national legislation to be more specific on the scope of SME exposures, if relevant.

Primary Cover Assets: Exposures to SMEs

- Unsecured exposures: In many cases, loans to SMEs will be granted without security on the basis of the business model and/or the financial strength of the borrowing entity. Indeed, micro-enterprises might be less able to provide collateral.

- Secured or collateralised exposures: SME loans might be secured or collateralised either by the borrower or by a third party, including public entities or promotional banks. It is worth noting that the type of available collateral is characterised by a broad range of tools in line with the customary finance techniques in Member States. It appears therefore difficult to provide a more specific breakdown of eligible collateral. All types of securities and collateral shall be legally enforceable. Valuation standards applicable to secured financing for ESN would need further assessment.

  With regard to real estate collateral, the established funding instrument is the traditional mortgage covered bond, so in principle mortgage loans to SMEs will probably only be considered for ESN funding if the loan characteristics don't comply with the scope of the Covered Bond Directive (i.e. not compliant with requirements in Art. 6 of the CB Directive) .

- Legal requirements: It shall be ensured that the institution issuing the ESN has a claim for payment which shall be subject to the following legal requirements: The asset represents a claim for payment of monies:

  - that has a minimum value that is determinable at all times
  - that is legally valid and enforceable
  - that is not subject to conditions other than the condition that the claim matures at a future date

- Other characteristics:

  - There is no evidence for the need of specific provisions addressing the maturity of exposures provided that the necessary over-collateralisation requirements are met.
  - The exposure-based approach would also recognise financial leasing transactions as eligible cover assets.
  - Further assessments should be carried out regarding revolving loan structures and credit lines that in some Member States represent a significant proportion of SME finance. While structural impediments triggered by

[1] i.e. the exposure of a borrower within the underlying pool

such assets cannot be identified at first glance (see ABS transactions purely based on revolving loans), an in-depth analysis of all relevant specificities is recommended.

- As described above, loans to individual entrepreneurs (no legal corporations) represent a significant proportion of business loans and comply with the current definition of SME at EU level. It is noted that in other jurisdictions, micro businesses are not an essential part of the SME sector and therefore not a target for a potential ESN funding tool.

- Further research should be carried out as regards the development of Green and Sustainable ESNs in line with the EU taxonomy on sustainable finance and in compliance with the Green Bond standards.

Substitution Cover Assets

Substitution assets can be used in case there is a breach or risk of breach in the coverage requirement of a given ESN programme. Therefore, in order to ring-fence further assets to the benefit of the ESN-holders, substitute assets may be identified, such as public sector bonds or bank liabilities. The TF should investigate further possible substitution assets and any maximum amount in the context of the programme.

Derivative Contracts

The TF recommends that derivative contracts shall be allowed to be included in the cover pool for risk hedging purposes, more precisely for the hedging of interest rates, foreign exchange and liquidity risks. The cover pool eligibility requirements should be the same as those defined for traditional covered bonds. (Please also refer to section on Micro-Structural features below)

3. Quality Criteria at Exposure and Cover Pool Levels

As a dual recourse instrument, ESNs are correlated with robust credit quality standards and investor protection features. Certain rating targets shall be achieved in order for the instrument to reach the intended spread performance and funding conditions on capital markets[2]. In consequence, sufficiently prudent eligibility criteria should be defined and a number of risk mitigation criteria should apply at cover pool level.

Exposure Level

In front of the variety of SME structures and the related diversity of credit and liquidity risk profiles, it appears particularly challenging to design a common European metric for the assessment of credit qualities. It is obviously not suitable to use a loan-to-value based approach for the credit quality measurement of SMEs as is the case for mortgage covered bonds. Any credit quality metric should furthermore be usable by all banks in order not to discriminate between more sophisticated institutions applying internal models and institutions using a standardised approach. ESN should in fact be a financial instrument for all banks funding the corporate sector.

There is general consensus that assets to be included in the cover pool shall be performing, i.e. no defaulted or bad loans. In this vein, considering the unprecedented situation caused by the COVID-19 pandemic, the TF shares the view that loans in payment holiday should also be considered as eligible assets (as long as they are not classified as NPL under an accounting or prudential perspective).

"Sound and well-defined credit underwriting standards" as defined by the EBA "Guidelines on loan origination and monitoring" published on 20 May 2020 shall apply. These Guidelines are comprehensive and could also help in defining certain ESG characteristics of the underlying loans.

As regards credit quality, institutions using internal rating models could define a minimum quality level as an equivalent to a maximum level of probability of default (PD): above a defined PD limit the loan would not be eligible for the inclusion in the cover pool. Such maximum level should be thoroughly investigated.

[2] Rating targets will vary between Member States and issuing entities due to rating constraints imposed by applicable sovereign rating caps as well as issuers' default ratings which will impact on the maximum achievable rating of the ESN.

Credit institutions using the standardised risk approach could also develop scoring models for SME exposures. Depending on their risk appetite, tangible criteria based on e.g. industry characteristics, availability and type of collateral, competition and innovation power, market penetration and customer behaviour, profitability (return on equity), debt-equity ratio (credit limits), loan size, credit payment and default histories or management/owners' and employees' qualification could concur to a credit quality assessment. The required minimum credit score is a function of the targeted funding conditions to be achieved by the ESN.

In addition, the appropriateness of criteria currently used for collateral management by the Eurosystem of the "credit claims", ECB applies strict criteria in order for such assets to be eligible for collateralised funding transactions under the general criteria for such collateral: above a certain PD the asset is excluded and cannot be part of the cover pool. In substance the maximum PD level is consistent with an investment grade rating of the counterparty (BBB-). Such criteria could have the merit of following rules already existing and applied by the Eurosystem to all banks (IRB and Standardised). Credit claims are a source of ECB funding currently used by banks belonging to different EU jurisdictions.

In addition to the general criteria the ECB allows national central banks to set their own criteria in specific cases ('Additional Credit Claims' or 'ACC') in order for banks to be able to use their facilities in adverse scenarios with other safeguards put in place.

The provision of funding in adverse scenarios is an important feature of ESNs and the Task Force will continue to investigate a possible metrics applicable to all financial institutions in both 'business as usual' and adverse conditions having regard to the importance of ensuring consistency between the quality criteria and that applied by the ECB.

It has also to be assessed if such quality of the collateral at the time of inclusion in the cover pool should be measured at individual level or as an average at portfolio level. In principle, both options could be pursued, the latter being more flexible.

Finally, a last aspect shall be taken into consideration at SME exposure level: human capital qualification and corporate governance. SME credit quality is intrinsically impacted by management skills, the qualification of the personnel at the head of the enterprise and by corporate governance standards. It is recommended to investigate the possibility of defining common qualification requirements for the SME managing personnel and for the governance at European level.

Cover Pool Level

A second layer of discussion concerns possible general concentration limits within the cover pool (e.g. concentration per amount, per sector, per geographical region of origination). Such pre-defined limits could have, on the one hand, the merit of harmonising the cover pools of the different ESN programmes across countries. But on the other hand, they would prevent the recognition that cover pools belonging to different jurisdictions may follow different compositions (in terms of economic sector or geographical distribution). The latter argument has for instance been considered also by the EBA (when presenting its 2018 report on ESN), highlighting that ESN should follow the different economic structure of the country/region where the programme is established. Therefore, any concentration limit could be set at programme level in the context of the definition of the cover pool criteria, rather than being decided as a fixed rule for each ESN programme.

A decent level of over-collateralization in combination with a sufficient level of granularity of SME loans are further appropriate criteria to securing the cover pool against asset volatilities potentially triggered by shorter maturity profiles and to compensate for credit losses, thus enhancing the credit quality of ESNs.

The level of homogeneity of the cover pool is another valid driver for the risk profile of the ESN as well as for rating purposes (see also some considerations on OC and homogeneity of cover pools in Part III, under "Additional Rues that might be required").

As far as a clear proposal for maximum credit risk on a loan level is found, a process for loans within the cover pool becoming non-performing has to be identified. For instance, if a borrower fails to pay for more than 90 days the loan has to be taken out of the cover pool and/or excluded from the calculation of the coverage requirement. In this context, as regards the objective of avoiding pro-cyclicality, further analysis is recommended once an ESN programme is launched.

The TF recommends further exploring suitable approaches and/or tools for the measurements of credit risk.

Conclusion

The aim of this chapter is to providing a comprehensive overview and raising awareness as regards the main credit quality criteria attached to SME lending. Because of the variety of SME structures and credit products applied, it is particularly challenging to define valid common credit quality ratios or minimum criteria at exposure level which would be suitable to be included in a potential European ESN Directive. For a number of credit quality drivers, it appears more consistent to defining the relevant technical ratios and/or requirements at national level (transposition law) or even at the level of the individual ESN issuing institution (e.g. voluntary self-commitment).

Next Steps

SME definition:

The TF recommends further assessing the scope of the SME definition in order to release the full potential of the ESN instrument

Asset eligibility:

The eligibility of revolving loan structures and credit lines should be assessed.

Further research should be carried out as regards the development of Green and Sustainable ESNs in line with the EU taxonomy on sustainable finance and in compliance with the Green Bond standards.

Quality Standards at Exposure and Cover Pool Levels:

Further research on appropriate credit risk measurement tools/metrics is recommended

Analysis of Structural Features

Macro Structural Features - Potential Structures

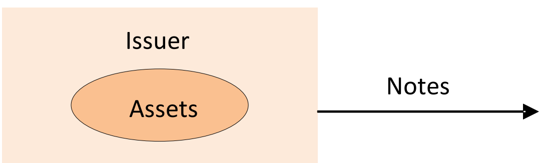
This Section illustrates some of the structures that European Member States can consider when looking to identify a viable on-balance sheet structure that will allow the issuance of ESN as a dual recourse funding tool for credit institutions. The analysis summarises the 4 structures currently used by member states for the issuance of covered bonds and some of the structured and legislative ESN structures already adopted in Europe (for example the Obbligazioni Bancarie Collateralizzate (OBC), Commerzbank Structured Covered Bond and French ESNIs).

Although the TF believes that the 'default option' in any given Member State will be that the same macrostructure currently used for covered bonds may also apply for ESNs there are some plausible reasons why this might not be optimal, in particular if some aspects of the choice of macro structure may in practice exclude certain lenders. Examples of this include cases where the use of a specialised mortgage credit institution may be too expensive for smaller lenders, or cases where a negative pledge in existing loan documents prevents the ring fencing of assets under existing arrangements or cases where Member States may want to implement joint funding/pooling structures given the smaller size of existing SME portfolios. In these cases Member States may decide to deviate from the existing macrostructure used for covered bonds and implement one of the other proposed structures.

1. Classic Direct On-Balance Sheet Issuance

This structure mirrors the ring-fencing on balance sheet structure that is already used for covered bonds in various European jurisdictions. Pursuant to this issuance model, the ESNs are issued by a bank without the transfer of the assets to an external entity. The assets are segregated (or ring-fenced) through a pledge on balance sheet or registered in a special register. Bondholders benefit from a direct, unconditional dual recourse to the issuer and the cover pool of assets. While this structure may be quicker to set up at issuer level since there is no need to establish a separate Special Purpose Vehicle (SPV). Adopting this model however could require substantial changes to the bankruptcy and security law in some jurisdictions to ensure the effective segregation of the assets in the register: in some countries, segregation of assets and swaps on balance sheet could not be possible at present due to constraints related to the relevant legal and regulatory frameworks.

Classic Direct On-Balance Sheet Issuance



Key Characteristics

- Issuer of the ESN is a credit institution
- Dual recourse is achieved first in relation to the credit institution and then to the pool of segregated assets
- Specific register or pledge on the pool of assets
- Assets are segregated in case of insolvency of the issuer for the benefit of the ESN holders
- Investors should have preferential claim over the pool of assets with respect to other creditors of the issuer
- This structure is used for covered bonds in Germany, Spain, Denmark, Greece, Cyprus and Belgium, among others

Implications

Bank issuing ESNs and asset segregation on-balance sheet

Advantages

- Simple structure, easy to understand (comparable to traditional German covered bonds)
- No need to transfer assets to a different entity, hence no need to set up a SPV
- Direct dual recourse: investors have first recourse to the issuer and a preferential claim on the pool of assets

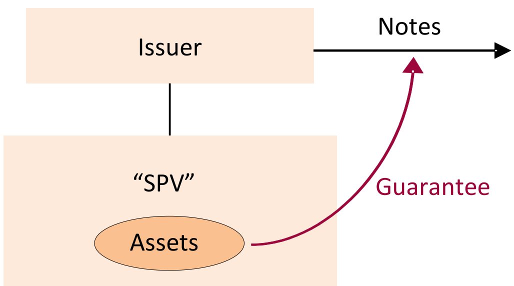
Potential Disadvantages

- Could require substantial changes to bankruptcy and security law in order to avoid challenges from other creditors and conflict with existing negative pledge provisions
- Segregation of assets and swaps on-balance sheet may not be possible in certain countries in their current legal set up

2. Direct Issuance with Separate SPV Guarantor

The ESNs are issued by a credit institution while the assets are transferred to a separate legal entity, an SPV, that guarantees the notes issued. In this case the legal framework should: (i) allow the transfer of assets using the securitisation approach; and (ii) address potential limits on intra-company exposures. Dual recourse is achieved via the guarantee provided by the SPV. According to the guarantee mechanism, after an issuer event of default the Guarantor steps in and the cashflows from the assets (including the proceeds from a potential sale of the assets) are used to satisfy the obligations arising from the ESNs.

Direct Issuance with SPV Guarantor



Key Characteristics

- Similar to covered bond structures that were developed before the covered bond law existed in various countries such as in the UK
- The issuer remains the bank but the assets are transferred off balance sheet to an SPV, guarantor
- Used when existing law allows transfer of assets using securitisation technologies effectively
- Used for covered bonds in Italy, the Netherlands, etc. Furthermore, please note that this structure was used for the Commerzbank SME Covered Bond and is the structure currently contemplated for OBC in Italy

Implications

Issuance by the bank itself while the assets are transferred to a separate legal entity that guarantees the notes issued

Advantages

- Assets transferred to a legally separate entity, which makes it easier to identify them in case of insolvency of the issuer and investors claiming on the assets

- Clear cut segregation of the assets with respect to the general insolvency estate of the issuer
- Most activities remain at bank (Issuer/Originator) level, the SPV's only role is to provide the guarantee for the benefit of the ESN holders

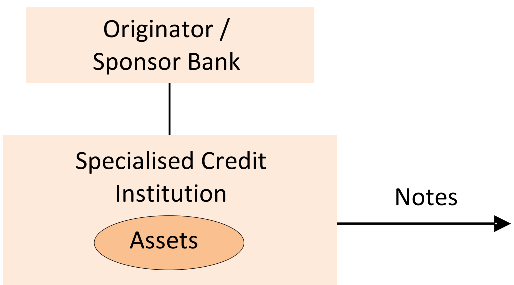
Potential Disadvantages

- Separate entity/SPV will need to be able to provide the guarantee legally
- Separate entity will need to be established, so the process for establishment of the ESN programme can be longer
- Regulatory limits on intra-company exposures typically need to be addressed by the existing law

3. Specialised Credit Institution Model

The ESNs are issued by a separate entity called 'Specialised Credit Institution' exclusively dedicated to the issuance of the ESNs and the management of the pool of assets backing those issues. This model requires the set-up of an ad hoc company which is a duly licensed and supervised specialised credit institution. The ad-hoc companies are subsidiaries which are totally distinct from the other entities of the group to which they belong. They have a limited purpose which is granting or acquiring eligible assets and financing them by issuing ESNs, to provide in turn financing to the sponsor bank. The ESN proceeds are generally used to fund advances to the respective sponsor banks. The notes are secured by the legal privilege over the assets of the issuer, which are advances to the sponsor banks, which are in turn secured by a pledge over cover assets such as residential mortgages which remain however on the sponsor bank's balance sheet.

Specialised Credit Institution Model



Key Characteristics

- Issuer of the note is a 'Specialised Credit Institution', which is a duly licensed subsidiary of the sponsor group but is limited in the scope of activities it can carry out
- The assets are segregated in the 'Specialised Credit Institution'
- Used for covered bonds in France and Poland

Implications

Issuance by the specialised credit institution and assets segregated by the entity

Advantages

- The regulatory framework allows for a segregation of the loan receivables without a 'true sale' to the issuer. For example, in France segregation is achieved via: (i) remittance, (ii) pledge or (iii) transfer by way of security of the full title

Potential Disadvantages

- Set up of a specialised entity that is more than an SPV: the entity needs to be duly licensed and obtain a banking license
- The legal system in some countries that currently do not envisage this structure for covered bonds may need to be amended to provide for the setup of this type of entities. The insolvency legal framework also needs to provide for an exception such that bankruptcy proceedings or liquidation of the sponsor company cannot be extended to the specialised entity: ultimately the specialised entity needs to enjoy full protection from the risks of default by their parent company or the group to which it belongs

4. Joint Funding/Pooling Structure Model

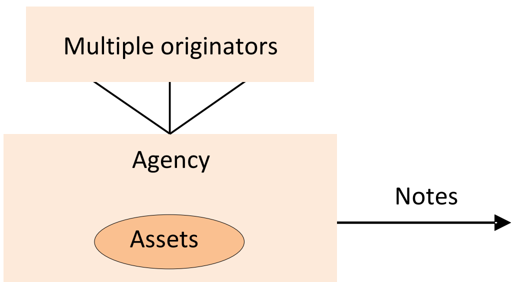
This fourth structure has been introduced to allow credit institutions to pool their SME assets. It mimics the joint funding model that have been recently clarified by article 9 of the Covered Bond Directive. The TF believe that this structure will be of particular interest to Member States who aim to find new funding solutions for their SMEs, especially in cases where credit institutions have smaller SME portfolios compared to residential and commercial mortgage portfolios. Public intervention may also be foreseen in certain circumstances.

An agency aggregates eligible assets from multiple originators (e.g. smallerlenders) in order to combine funding needs. By pooling the cover pool assets, lending costs can be reduced and issuers can provide larger and more liquid securities - ESNs. The agency then lends the proceeds back to the originators on a full dual recourse basis secured on the pool of assets. The structure shares many of the characteristics of and is frequently seen as a substitute for covered bonds.

There are substantial structural variations for existing mortgage agencies, for example whether they are established by specific statute (Pfandbriefzentrale in Switzerland) or are purely contract based (Sparebank Boligkredit in Norway), whether they are publicly owned (CMHC in Canada), privately owned (CRH in France) or mixed (Cagamas Berhad in Malaysia) and the details of the products that they offer.

Despite such differences, an aggregating model could be viable either within individual Member States or potentially on a regional or pan-European basis in order to serve the needs of lenders to the SME sector in particular for those who for reasons of size or rating are not currently adequately served by existing covered bond structures.

Joint Funding/Pooling Model



Key Characteristics

- Eligible assets from multiple originators are aggregated together in a single cover pool by a separate agency
- Cost savings enable issuers to provide larger and more liquid notes
- Dual recourse is achieved
- Used for mortgage lending in Switzerland, Norway, France, Canada and Malaysia among others

Implications

Issuance by multiple originators whose eligible assets are pooled together by a single agency

Advantages

- Lower costs, achieved through efficient pooling of assets from multiple originators, enables issuers to provide larger and more liquid notes
- Suited to lenders who may be constrained by size and rating limits and therefore not adequately served by traditional covered bond structures

Potential Disadvantages

- Existing mortgage agencies differ substantially from each other depending on a number of factors which may pose a challenge when choosing standardised model for ESN issuance

Micro Structural Features – Potential Amendments

Micro Structural Features Analysis	
Asset and Liability Matching	Although the Covered Bond Directive does not require member states to put in place rules regarding maturity mismatches (ie. the difference between the principal repayment profile of the assets included in the cover pool and maturity profile of the ESNs), the laws of some member states or specific regulations covering CB issuing structures require it. Given that there will be a variety of rate basis and terms for the underlying assets and bonds may be produced both in the more traditional fixed rate format and on a floating rate, presumably for use as repo collateral, it would be difficult to generalise as to rules to limit duration mismatches. Some member states will need to amend their existing rules on a case by case basis and other member states may need to introduce such rules for the first time.
Derivatives (Article 11)	The rules regarding derivatives in the Directive are unlikely to require major changes. However, some member states may need to introduce rules implementing Article 11 of the Directive, in particular where hedging is currently typically undertaken by the matching of term fixed rate assets and liabilities (mainly those member states with longer fixed term mortgage loans but floating rate loans to SMEs). It is also possible that the derivatives required for the new collateral classes may be greater in volume than they are currently, or put additional stresses on a structure that may need to be addressed (for example, loans to infrastructure projects may be denominated in a different currency requiring FX hedges in the cover pool. If the covered bond law currently only covers minor interest rate mismatches on mortgage books it may not be sufficient for the additional stresses). It is possible that the need for derivatives in these cases may influence the 'macro-structure' decision, for example in jurisdictions with an on balance sheet model but where issuers cannot undertake derivatives with both legs in the same legal entity.
Set-off Risk	Set off risk (ie. ability of the borrower to net any assets they hold with the issuing entity and their liabilities under the loan in the cover pool) in residential mortgage backed covered bonds is typically addressed by one or more of either statutory rules, amendments to underlying loan terms and conditions, structural features and reliance on deposit guarantee schemes. These may be impossible or inadequate in the case of loans to SMEs who are more likely to have exposures above deposit protection thresholds or project finance loans which will almost certainly have more complex financial relations with the bank. This adds a layer of complexity to the risk and may require changes, for example to national laws to explicitly exclude set-off in order to achieve the same result.
Commingling Risk	Commingling risk is the risk of collections and other amounts deriving from the cover pool not being segregated for the benefit of the ESN holders from the general insolvency estate of the Issuer. The nature of commingling risk in ESNs will be similar to the risk for traditional covered bonds. However, the amount of collections potentially lost may be higher in the case of SME loans because the repayment speed is much quicker as SME loans tend to be shorter dated compared to residential mortgage loans. This risk could be mitigated by ensuring, by law (as the case in most covered bond legal frameworks), the segregation of the cash flows from all cover assets from the issuer's insolvency estate or where this will not be possible by introducing contract based structural features (for example the creation of a commingling reserve).
Disclosure Requirements (Article 14)	The Directive (Article 14) and Capital Requirements Regulations ("CRR") (Article 129) provide a broad definition of information that must be disclosed to investors regarding the assets underlying the covered bond. Most national laws and regulations contain more onerous requirements and, in practice market initiatives such as the ECBC covered bond label are based on a yet higher level of disclosure. The required information disclosure for an ESN will be different, but could be in line with the general principles as defined in Article 14 and Article 129 ("sufficiently detailed to allow investors to assess…the risks"). Alternatively, as asset eligibility and credit details are likely to be less precise and less homogeneous across Europe than in the case of mortgages as underlying collateral, there is an argument for a higher level of disclosure for ESNs to allow greater investor analysis. In either case the details to be disclosed should be defined on a national level as the parameters that will be important in each jurisdiction will differ depending on the products typically used. Some questions will need to be considered such as: are they secured? Are they leases? Mainly used to fund working capital or capex?

Micro Structural Features Analysis	
Eligible Assets (Article 6, CRR Article 129, National Laws)	All rules defining eligible assets will need to be reconsidered. It should be considered whether the principles defined in Article 6 are appropriate, for example, if there is security over collateral, the requirement for generally accepted valuation standards. Also, it should be considered whether the likely differences in the underlying asset in different member states will make it impossible to agree a common EU definition but rather favour a principle-based definition at EU level and a requirement for the more detailed rules to be defined at a member state level. If so, further thought is required on the nature of the principle and other factors (credit metrics, ease of valuation, strategic importance, other principles e.g. credit quality, concentration/diversification by industry/geography etc.)
Non EU Assets (Article 7)	Given the intent of the instrument is primarily to channel funding to Europe's SMEs and also the greater uncertainty with regard to the legal enforcement of security interests outside the Union, it may be appropriate to exclude assets outside the Union (presumably defined to include EEA, and the candidate accession countries) from cover pools.
Liquidity Buffer (Article 16)	Whilst a liquidity buffer is likely to be needed in practice, it could be considered whether the calibration of the liquidity test with reference to 180 days of net outflows is appropriate given national variations in the ability to refinance the underlying assets of ESNs. 180 days is presumably calibrated as a reasonable estimate of the time to liquidate a portfolio of mortgages via sale, securitisation or other refinancing. On a case by case basis it may be reasonable to assume a different period is required to refinance loans to SMEs or project finance loans. Whether this should be on a pan-European basis or a member state basis is debatable. Furthermore, it may be worth considering to calibrate the liquidity buffer to the rating agencies requirements currently ranging between 3-6months of principal, interest and senior expenses.
Extendable Maturity Structures (Article 17)	The conditions for extendable maturity structures in Article 17 could be identical for ESNs. However, given that in many cases the underlying assets are likely to be shorter than the bonds issued to fund them, it should be considered whether a new article is required to define the conditions for acceleration of bonds and whether this should also be allowed only subject to conditions in this article such as those defining objective triggers.
Labelling (Article 27)	Despite the common features there should be a very clear distinction between 'ESN', 'European Covered Bonds' and 'Premium European Covered Bonds' and respective translations into other languages as defined in Article 27 of the Directive. 'European Secured Notes' and translations of that phrase should similarly be protected terms.
Coverage Requirements (Article 15, CRR Article 129)	The coverage requirement in Article 15 of the Directive and more importantly in the amendment to Article 129 of the CRR will clearly need to be reconsidered to take into account the different risk characteristics of the underlying assets. Further consideration is required as to whether it is appropriate or realistic to set a minimum coverage ratio on an EU wide basis at all. The proposal of the European Banking Authority in this regard (30% coverage requirement) would be a significant deterrent to the development of this market, in particular if compared to the average coverage for securitisations of SMEs.

Structural Details That We Do Not Consider Need To Be Changed

We would envisage no change to be required to the following articles in the Directive:

1. Dual recourse (Article 4)
2. Bankruptcy remoteness (Article 5)
    a. Although, the above comments with regard to the greater probability of acceleration should be taken into account. This article currently only states that acceleration should not be 'automatic, in case of issuer insolvency or resolution'
3. Pooled / Joint funding (Article 8, Article 9)
    a. Composition of the cover pool (Article 10)
4. See also below with regard to additional rules that might be required
5. Segregation of assets (Article 12)
6. Cover pool monitor (Article 13)
7. Supervision and reporting (Articles 18 - 26)

Additional Rules That Might Be Required

Given the potentially greater risks in the underlying assets relative to more traditional asset classes it may be appropriate to introduce new requirements to improve the protection for investors. For example, detailed rules ensuring a more homogeneous cover pool, imposing limits on concentration in individual sectors and ensuring the credit quality of third party service providers might all be considered appropriate. Worth considering if we should also include a minimum OC level which will most likely be in excess of 5%.

However, any new rules should take into account that they will be more burdensome in some countries than others: high rating requirements for service providers for example are more onerous (may be impossible) in less well rated Member States.

Alternatively, rules limiting excess exposure to one industrial sector may be appropriate in highly diversified economies (such as Germany) but less so in countries with more concentration on individual sectors (such as Greece).

Furthermore, any new rules should be cognisant of the appropriate balance between the roles of legislation and supervision and that of market discipline.

Finally, the Task Force would like to further consider other topics such as disclosure requirements, rating agencies criteria as well as ESG requirements currently not contemplated in this paper.

Conclusions:

The TF has identified both the key macro and micro structural features for ESNs. We have suggested 4 potential structures that Member States can implement for the issuance of ESNs. Member States will be free to choose a structure that deviates from the one used for the issuance of covered bonds and better fits their SME portfolios. Furthermore, we have identified a set of micro structural features which refer to aspects what will need to be considered or changed relative to the existing local covered bond laws or the EU covered bond directive.

Next Steps:

- Definition of the minimum disclosure requirements and rating agencies criteria which both will depend/are driven by the outcome of the definition of eligible cover assets for ESNs.
- Identification of a minimum set of ESG parameters that the cover pool and structure will need to satisfy.

Appendix

ESN Questionnaire
1. Do you prefer see ESN as a funding or capital relief or both purposes instruments? Which are the implications to enlarge the purposes on the market and regulatory point of view?
2. Which is the preferential regulatory treatment envisaged to have on ESN in order to stimulate market appetite and improve the efficiency as funding instrument? Please suggest two different priorities in the regulatory treatment expectations

3.	What has changed since the July 2018 report that would influence the business case for ESNs (recent COVID-19 Impact)?
4.	Which issuers and/or jurisdictions and/or future scenarios may have constraints on the availability of traditional covered bond assets?
5.	Under what scenarios, if any, could an ESN be a more attractive investment than a traditional covered bond, ceteris paribus?
6.	Under what scenarios, if any, could an ESN be a more attractive funding instrument than a traditional covered bond or SMEs securitisation or unsecured funding instruments, ceteris paribus?
7.	Where could/should the ESN be positioned as funding tool vis-à-vis covered bonds / senior preferred both in terms of pricing/maturity/preferential treatment?
8.	What kind of collateral could be ideally eligible for ESN in order to make the funding instrument most efficient (example: new SME financing versus existing)? What are the main benefits and costs of expanding the definition of eligible assets from the base case (SMEs) to a broader definition?
9.	Could an ESN be combined with guarantees of EIB, EBRD be appealing to investors?
10.	Could ESN foster / incentive sustainable SME financing?
11.	How can an ESN be combined with capital relief for the underlying assets without losing its appeal to investors as a very low risk instrument?
12.	Which are the elements to take in consideration in order to determine the appropriate and potential prudential treatment of SME ESNs?
13.	How the Infrastructure ESNs could support sustainable development?

European Mortgage Federation
European Covered Bond Council
Rue de la Science 14A, 2nd Floor
B-1040 Brussels – Belgium
T. +32 2 285 40 30
info@hypo.org
www.hypo.org