

ECBC Response to the Green Paper on Building a Capital Markets Union

Analysing the Potential of a Dual Recourse Funding Instrument, European Secured Note (ESN), as a Source of Long-Term Financing for the Real Economy in the EU

12th of May 2015

EXECUTIVE SUMMARY

The **European Covered Bond Council (ECBC)**¹ welcomes the opportunity to respond to the public consultation on Building a Capital Markets Union launched by the European Commission on the 18th of February 2015. We fully support the goal of strengthening investment and funding for the long-term and the need to build a true single market for capital – a Capital Markets Union for all 28 Member States. There is no single measure that will deliver a Capital Markets Union but only an ensemble of solutions which will pave the way to achieve this goal. Against this background, the ECBC would also like to highlight the extremely crucial role that lies in the hands of the European Commission in co-ordinating market and institutional initiatives at national, European and international level. The ECBC, in the context of the current consultation, would like to provide practical market input and thank the European Commission for their ongoing commitment to a constructive dialogue.

The ECBC's concrete proposal in this area represents a market initiative based on consensus, which could significantly reduce market fragmentation by creating a new pan-European funding instrument based on a bottom-up approach. This initiative would require a limited legislative intervention at national level, which could be supported by the European Commission and other European Institutions playing a catalyst role and which could be implemented over a relatively short timeframe. More importantly, this initiative would respond to several of the priorities for early action foreseen in the Green Paper, in particular: (i) widening the investor base for SMEs, and (ii) building sustainable high-quality securitisation.

This paper is divided into two parts:

- Part one represents the ECBC response to the Green Paper, which outlines a proposal for the use of new dual recourse funding instruments, for simplicity tentatively called European Secured Notes (ESN).
- Part two sets out the basis of this proposal, i.e. the work undertaken by the ECBC Task Force on Long-Term Financing²;
- Annex I presents a case study on SME lending disclosure.

The ECBC response to the Green Paper on Building a Capital Markets Union aims at providing clear building blocks for a market initiative on a pan-European dual recourse long-term funding instrument, which would allow for the financing of asset classes beyond the traditional covered bond collaterals, i.e. mortgages and public sector assets. In particular, this proposal considers long-term financing

¹The European Mortgage Federation - European Covered Bond Council (EMF-ECBC) is registered in the European Institutions' Transparency Register under ID Number 24967486965-09.

² The ECBC established a Task Force on Long-Term Financing (LTF) at the end of 2014 gathering 20 market experts from 11 different countries with international expertise on long-term financing best practices and techniques. The objective of this group was to analyse and map the state of play of current initiatives on SME & long-term financing solutions at EU level, and to investigate any current or potential interest from/intentions of national and European legislators to use covered bond funding techniques as a model for dual recourse instruments with new collateral asset classes. For further information, please refer to Part II of this Paper.

solutions for non-traditional collaterals such as small and medium-sized enterprise (SME) or infrastructure loans which could be financed by using either:

- an on-balance sheet dual recourse instrument using funding techniques derived from those used for covered bonds; or
- an off-balance sheet solution which uses high-quality securitisation techniques that could also offer risk sharing (and capital relief).

This initiative, designed outside of the traditional covered bond space, aims at establishing the pillars for the creation of a pan European long-term funding portfolio, combining existing techniques and market best practices learnt during the crisis, for the establishment of an anti-cyclical funding toolkit for lenders that is also accessible in a stress scenario.

The proposed initiative should be based on the common adoption of the same set of micro foundations and technology, in particular in terms of eligibility criteria, definitions, risk parameters, data disclosure and IT solutions across European countries. More importantly, this initiative, which adopts a bottom-up approach based on a market consensus and on existing market best practices, could have the potential to be relatively quickly implementable in the current legislative landscape. This rapid legislative implementation would ensure a good level of regulatory recognition of a very high-quality product under a clear legislative and supervisory framework, which could trigger a virtuous cycle at European level, facilitating issuers' and investors' due diligence in terms of risk analysis and pricing.

We believe that in the current changing regulatory environment, ensuring concrete lending capacity in support of the real economy is becoming an ever more complex exercise. The enhancement of lending capacity and, at the same time, the guarantee of financial stability can only be undertaken simultaneously by ensuring the consistent coordination and alignment of national and European regulation as well as of international guidelines.

Therefore, the ECBC feels a responsibility to contribute to a road map for the European growth agenda and supports the initiative of the European Commission to identify regulatory burdens and bottlenecks, by proposing market initiatives that could lead to market solutions without the need for further heavy regulatory intervention.

Against this background, the ECBC is focusing its responses and clarifications on two key messages:

- Traditional covered bonds have ensured financial stability and access to capital markets during the crisis thanks to very precise macro-prudential characteristics. Any watering down of these qualitative characteristics, by enlarging the risk factors, could jeopardise the systemic importance of this asset class.
- In the light of the current discussion on both SME lending and infrastructure investment and high-quality securitisation techniques and standards, it is important to identify a demarcation line between the traditional covered bond space and the potential use of dual recourse techniques for other kinds of assets as collateral.

In conclusion, as a response to the call of Commissioner Hill to gather ideas and market intelligence through the Green Paper on Building a Capital Markets Union, and in order to develop better regulation by means of market initiatives that can support growth and lending to the real economy, in its role as market catalyst the ECBC remains at the complete disposal of the European Commission, to assist and support the development of any market initiative going forward. We believe that private sector stakeholders could play an even more crucial role in financing growth and the real economy if they were to be put in a position that would allow them to both take risks and price them by using pan-European market platforms providing the basis for a proper cross-border market analysis.

In a Nutshell

In the context of the Capital Markets Union debate, we analyse the potential for the creation of a new financial instrument in the European Union that could benefit from the market best practices of both traditional covered bonds (for funding purposes) and securitisation (for funding and risk-sharing purposes). This instrument, with the proposed name of European Secured Note (ESN), would cover a funding segment located between the traditional covered bond and the high-quality securitisation spaces, and would complement the long-term funding toolkit for European Lenders financing SME loans and potentially other types of assets, such as infrastructure loans.

This proposed financial instrument would have anti-cyclical features as it could also combine a robust legal and supervisory framework, dual recourse and standardised asset data disclosure. Indeed, two major implementation structures/options are presently identified for this potential financial instrument: (i) an on-balance sheet dual recourse instrument with a dynamic pool for long-term financing purposes; or (ii) an off-balance sheet dual recourse instrument with static pool that could also offer risk sharing (and capital relief) as a response to deleveraging needs, as well as promoting risk transfer and risk-sharing.

This proposed instrument, which ideally would be embedded in national legal supervisory frameworks (UCITS compliant), could contribute to the CMU growth objective by ensuring a substantial and positive regulatory recognition for this financial instrument that, regardless of the structure, focuses on SMEs. Regulatory incentives could be tangible in terms of eligibility for LCR, ECB and Bank of England repo, lower risk weight for the SME asset class in CRR and Solvency II, CRA III Regulation, bail-in exception, etc.

Various modalities and options for the national implementation of this instrument should allow regulators, supervisory authorities and market participants to identify the best way of introducing this instrument in the different market and legislative environments. This would: (i) facilitate a rapid legislative implementation of common pan-European qualitative standards with a bottom-up approach; (ii) guarantee homogenous and comparable characteristics; (iii) facilitate lenders' and investors' due diligence; and (iv) create the preconditions for a future pan-European cross-border SME financing landscape.

The ECBC proposes to act as the market catalyst in developing this pan-European initiative which should have, among other things, a transparent and comparable European-level market platform infrastructure setting, eligibility criteria, risk parameters and IT solutions.

Finally, the ECBC would welcome the intervention of the European Commission and other European Institutions as catalysts of this initiative by (i) supporting and coordinating institutional interventions which would ensure the implementation of a common set of guidelines at national level, (ii) promoting the national and supranational institutions' potential role in investing in or in guaranteeing some of the tranches of the off-balance sheet instrument proposed, (iii) considering in the future a preferable regulatory treatment of such a potential instrument, e.g. via repo or capital requirements, and (iv) setting clear guidelines in terms of micro foundations, e.g. SME categorisations and definitions.

ECBC RESPONSE TO THE GREEN PAPER ON BUILDING A CAPITAL MARKETS UNION: PROPOSAL FOR THE USE OF NEW DUAL RECOURSE FUNDING INSTRUMENTS

1. The ECBC and the Capital Markets Union

The European Covered Bond Council (ECBC)³ strongly supports the Capital Markets Union (CMU) initiative and the plan of the European Commission to create deeper and more integrated capital markets in the 28 Member States of the European Union (EU). Our Council aims at contributing to exploring ways of reducing fragmentation in financial markets, diversifying financing and funding sources, strengthening cross-border capital flows and improving access to finance for businesses, particularly small and medium-sized enterprises (SMEs).

The ECBC represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was launched by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of May 2015, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of the EUR 2.6 trillion outstanding covered bonds.

The ECBC strongly believes that an efficient and robust financial sector is a key driver for growth, and that a degree of harmonisation is essential in building a European capital market. Therefore, we will continue to work with the European Institutions in their efforts to form a new governance architecture and, thereby, also set the scene for a new financial landscape. In this sense, the European Commission has now officially launched the process for the creation of a true Capital Markets Union, aimed at completing what was started with the Treaty of Rome⁴, and developed more concretely with the Treaty of Maastricht⁵, where the single EU market, encompassing the free movement of people, goods, services and capital was enshrined, but never completed.

During the recent crisis, the covered bond asset class has confirmed its significant role as a crisis management tool (see Figure 1 below) able to ensure: (i) investors' confidence; (ii) financial stability; and (iii) long-term financing. The ECBC led the covered bond community in striking the balance between, on one hand, establishing a common European framework and, at the same time, taking into account the national specificities of every financial market tradition.

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⁴ http://europa.eu/eu-law/treaties/index_en.htm

⁵ http://europa.eu/eu-law/treaties/index_en.htm

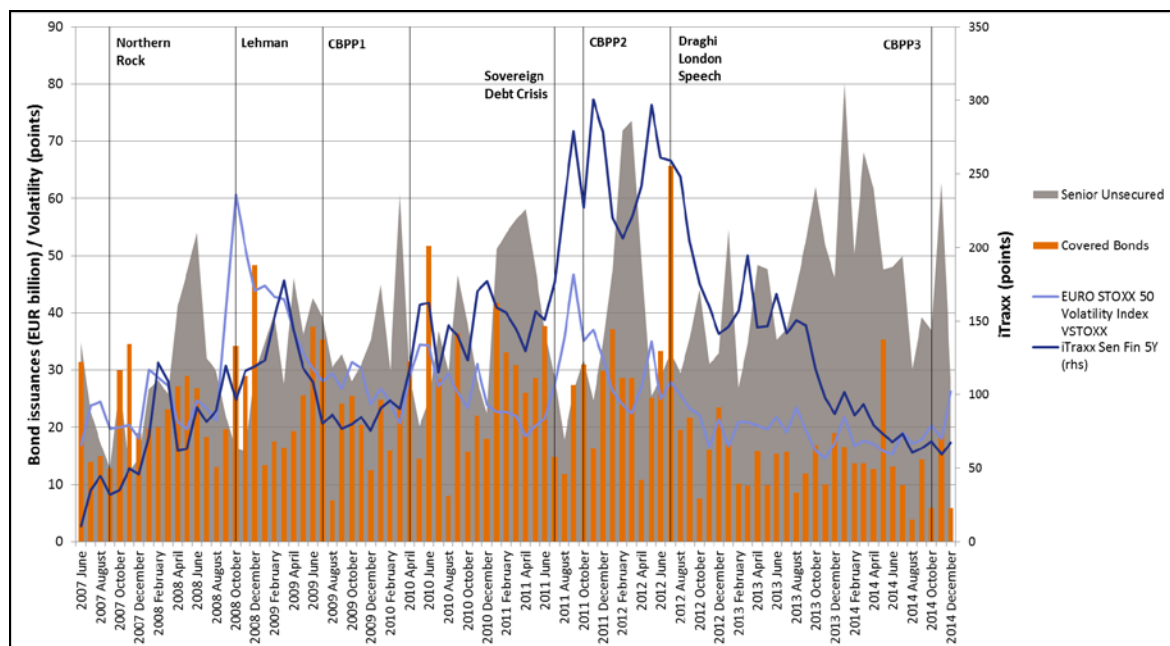


Figure 1: Covered Bonds as a Crisis Management Tool

Source: Bloomberg, EMF-ECBC.

Note: "Senior Unsecured" refers to all senior unsecured bonds (all face values) issued by "financials" in the EU in the given month. "Covered Bonds" refer to all covered bonds issued in the EU in the given month.

This target of principle-based harmonisation was achieved mainly by developing clear common qualitative guidelines based on harmonised data for disclosure and a self-certification principle.

Furthermore, the enhancement of transparency could be seen as an essential element in order to reduce the overreliance on external ratings under stress scenarios. In fact, this move has the twofold benefit of allowing investors' and issuers' due diligence in times of crisis, while ensuring quick responses by encouraging bottom-up legislative amendments of existing legal frameworks, including market best practices identified as key elements of resilience at European level.

A few years after its implementation, the Covered Bond Label has become an overarching umbrella that ensures an equal qualitative level of legal safeguard, covering a premium core segment of the covered bond market with high level transparency and comparability of data and definitions.

Covered Bond Label

The ECBC has made the clear commitment to enhance transparency in the covered bond market through the establishment of the Covered Bond Label (www.coveredbondlabel.com), a quantitative and qualitative database identifying premium sector of the CB market, which became fully operational in January 2013. This initiative, undertaken by the issuer community, was based on an intense and constructive dialogue between the investor community, major national and European authorities, as well as the main law firms active in the covered bond arena who have supported and followed the creation of the Covered Bond Label Foundation and its website. In its essence, the Covered Bond Label aims at providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. This transparency tool presents very detailed asset and liability side information and facilitates the investors' due diligence when comparing different issuer models, products in different markets and national supervision.

In the light of the Capital Markets Union and long-term financing debates, the ECBC has reacted to the effort by the European Commission to stimulate the growth of the EU's capital markets by mobilising a strong internal consensus in ensuring a principle-based harmonisation in the traditional covered bond space (which we consider to be defined within the remit of the Covered Bond Label) and providing input for developing a complete European long-term funding toolkit.

The role of the financial services industry remains a critical aspect of the European political and social landscape. Understanding the transmission channels that exist between the financial and other sectors of the economy is critically important when assessing financial stability. Robust financial systems are viewed as those that do not adversely induce the propagation and amplification of disturbances that affect the system itself, and those that are capable of withstanding shocks and limiting disruption in the allocation of savings to profitable investment opportunities.

Over recent years, the ECBC has held a very constructive exchange of views with market participants: issuers, investors and in particular with representatives of regulatory and supervisory authorities. Indeed, the core business of the ECBC is the building of bridges between different stakeholders, in different countries with a view to ensuring the continuous enhancement and smooth functioning of the covered bond market in Europe - and now, also at a global level.

We believe that in the current changing regulatory environment, ensuring concrete lending capacity in support of the real economy is becoming an ever more complex exercise. The enhancement of the lending capacity and, at the same time, the guarantee of financial stability can only be undertaken simultaneously by ensuring consistent coordination and alignment of national and European regulation as well as international guidelines.

Therefore, the ECBC feels a responsibility to contribute to a road map for the European growth agenda and supports the initiative of the European Commission to identify regulatory burdens and bottlenecks, by proposing market initiatives that could lead to market solutions without the need for further regulatory intervention.

2. Learning from the Success of Covered Bonds

In this pan-European spirit, the ECBC decided to use its high level of expertise and know-how in the field of covered bonds for the further development of capital markets in the EU by taking a number of steps towards the creation of new capital instruments. To this end, the ECBC established a Task Force on Long-Term Financing, the purpose of which was to investigate the possibility and viability of the creation of new capital instruments that make use of some key features that have made covered bonds one of the safest and most successful financial tools in use in Europe, and which played a central role in the crisis management toolkit of banks during the financial crisis by providing a safe and reliable source of funding.

ECBC Task Force on Long-Term Financing

The ECBC established a Task Force on Long-Term Financing (LTF) at the end of 2014 gathering 20 market experts from 11 different countries with international expertise on long-term financing best practices and techniques. The objective of this group was to analyse and map the state of play of current initiatives on SME & long-term financing solutions at EU level, and to investigate any current or potential interest from/intentions of national and European legislators to use covered bond funding techniques as a model for dual recourse instruments with new collateral asset classes. For further information, please refer to Annex I of this Paper.

The success of covered bonds is a result of the combination of all the different properties of this instrument, making it in some sense unique. Nonetheless, some of the core properties of covered bonds could be applied to different tools in order to create safe and reliable funding instruments. Three main characteristics of covered bonds could be used to this end: (i) a dual recourse structure; (ii) a robust legal framework; and (iii) a high level of asset quality and transparency.

How would such instruments differ from traditional covered bonds?

The creation of dual recourse instruments (so-called European Secured Notes (ESN) in this paper) would mainly differ from covered bonds in the collateral that is used to secure the bond. In the case of covered bonds, this is mainly mortgages and public sector lending. These highly standardised and low-

risk assets significantly contribute to the safety and stability of covered bonds, and this is the main reason why it is crucial to make a clear distinction between traditional covered bonds and any other dual recourse instrument backed by any other asset. Moreover, covered bonds would differ from such new instruments in the sense that their already established success and track record, together with their robust national legal frameworks makes them all the more reliable and stable. This aspect could, however, be developed by ESNs over time.

The work of the ECBC Task Force on Long-Term Financing has resulted in a comprehensive evaluation of the possibility of creating such ESNs. The Task Force was divided into four Work Streams, each focusing on a different aspect of the issue: **Work Stream I** focused on the identification of core common macro-prudential and legal characteristics of dual recourse instruments in order to secure bondholders and other creditors of the issuing institution; **Work Stream II** on the mapping of current interest and developments in the implementation of other collateral in dual recourse instruments; **Work Stream III** on the analysis of investors’ needs and perspectives, including the identification of transparency and risk assessment parameters; and **Work Stream IV** on the definition and analysis of a potential European toolkit for a dual recourse funding model implementable at national level, in particular analysing the issuer’s perspective and identifying potential blocking factors. For further information, please refer to Annex I of this Paper.

3. Designing Dual Recourse Instruments for the Long-Term Financing of the Real Economy

With the spirit of the Capital Markets Union in mind, the ECBC Task Force on Long-Term Financing tried to design new bank funding tools aimed at improving banks’ ability to lend to the real economy, while at the same time stimulate the growth of SMEs by promoting the use of SME loans as collateral for new ESNs. The outcome of the discussion was the proposal of two ESNs, each with slightly different characteristics, aimed at providing different benefits to the lender as well as to the borrower. The first ESN would be closer in design to covered bonds in the sense that the collateral would stay on the balance sheet and the investor would have dual recourse to both the pool and the issuer. The second ESN would resemble more closely what is referred to as “high-quality securitisation”. This could provide risk sharing (and capital relief) to the issuing institution (as the collateral would be transferred onto an SPV⁶), but still retain a form of dual recourse. In both cases, the collateral could be SME loans.

The importance of SMEs for the EU economy

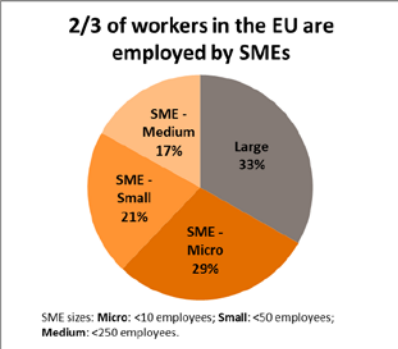
SMEs account for:⁷

- The employment of 88.8 million people
- 3,666 trillion EUR of value added (28% of EU GDP)
- 99 out of 100 business in the EU

The needs of SMEs are very different and face different risks, all of which need to be considered when addressing SME funding challenges.

With respect to the availability of information for SME loans, academics, credit rating agencies, investment banks and several think tanks have been publishing research on SME ABS performance across EU jurisdictions, covering a considerable number of years and giving valuable statistics on SME portfolio performance including stress periods. For further information, please refer to Annex I.

Figure 2. % of EU workers employed by SME



2/3 of workers in the EU are employed by SMEs

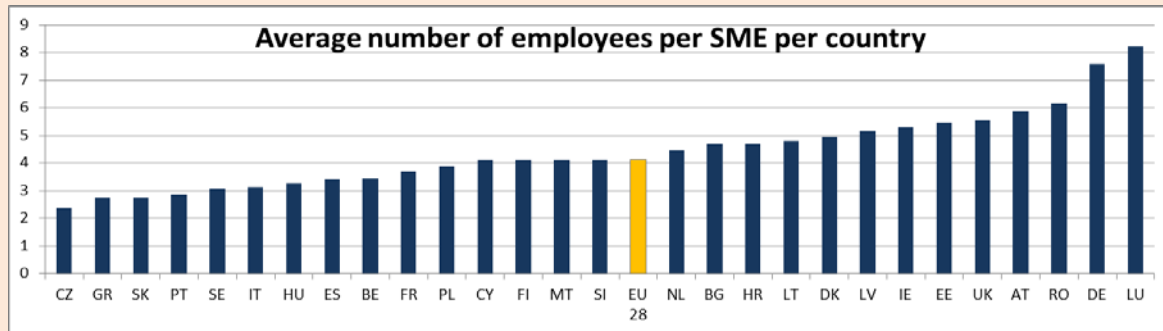
SME sizes: **Micro:** <10 employees; **Small:** <50 employees; **Medium:** <250 employees.

Source: European Commission, EMF-ECBC

⁶ Special Purpose Vehicle (SPV).

⁷http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2014/annual-report-smes-2014_en.pdf

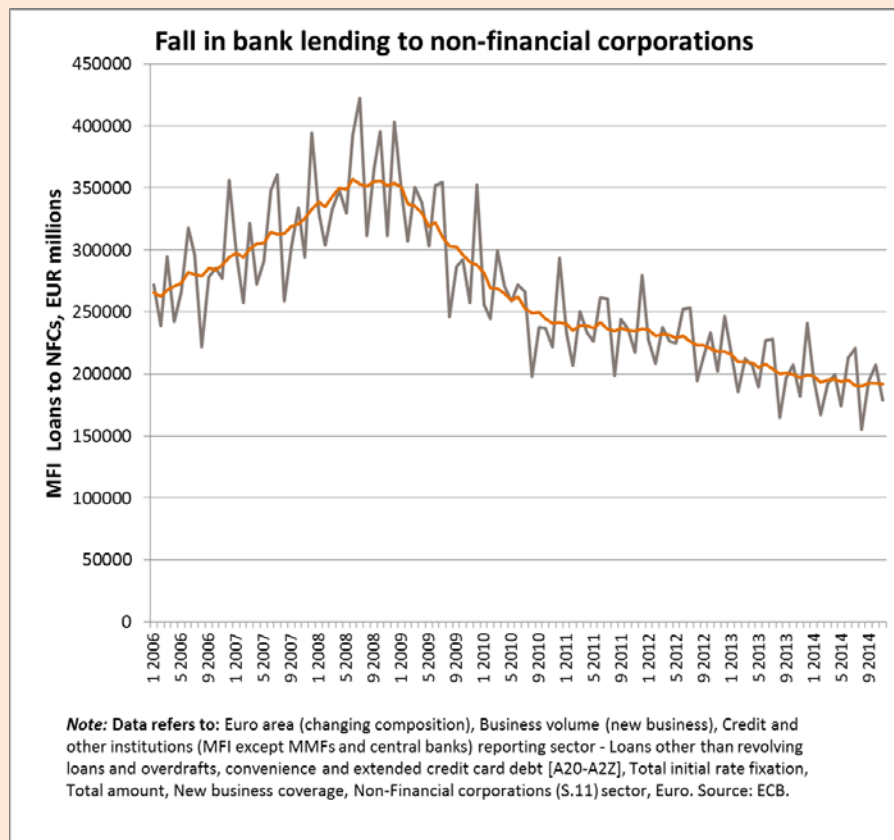
Figure 3. Average Number of Employees per SME per country



Source: European Commission, EMF-ECBC

Figure 4. Bank lending levels in the Euro Area⁸

There has been a considerable fall in lending to non-financial corporations since the start of the crisis and therefore, enlarging the set of funding instruments that could be used by SMEs (among others), could be particularly helpful. Indeed, enlarging the EU long-term funding toolbox in this direction could also be beneficial to maintain the anti-cyclical and stable lending capabilities of small- and medium-sized banks, which play a crucial front-line role in supporting industrialisation in clusters, (i.e. groups of specialised enterprises and other supporting actors that cooperate together in a particular location and where SME participation leads to more innovation and growth⁹). The standardisation of risks in these clusters could alleviate the assessment difficulties and could significantly enhance the attractiveness for investors of SME operating within the cluster.

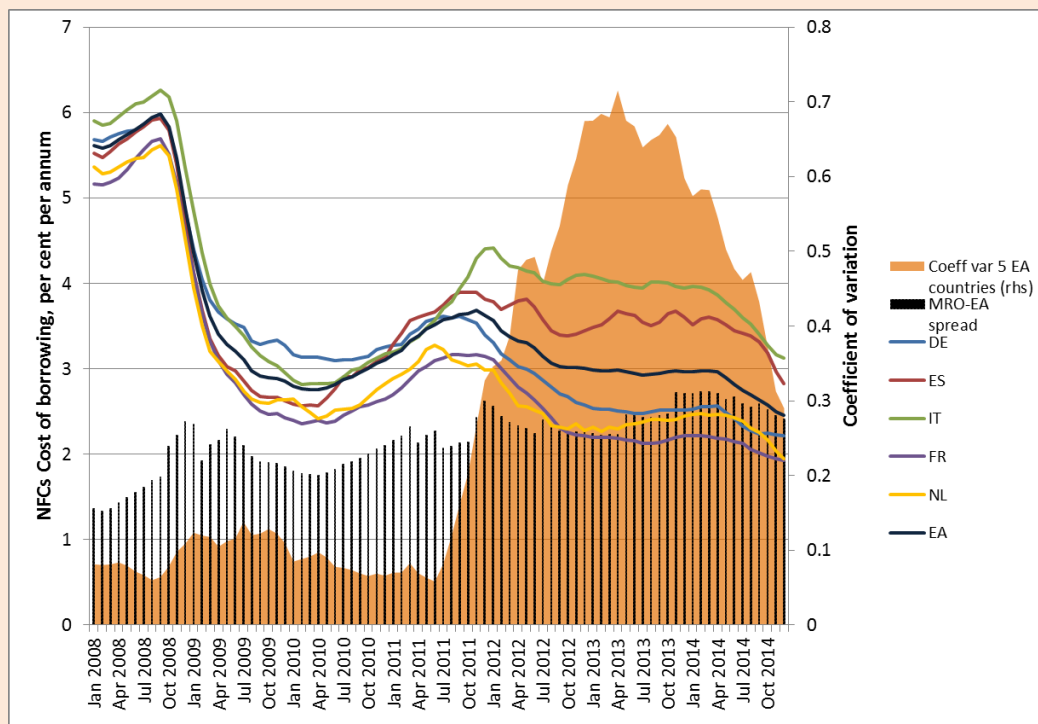


Source: European Central Bank, EMF-ECBC

⁸http://sdw.ecb.europa.eu/browseSelection.do?DATASET=0&BS_ITEM=A2A&MATURITY_NOT_IRATE=A&AMOUNT_CAT=A&node=9484373

⁹ http://ec.europa.eu/growth/smes/cluster/index_en.htm

Figure 5. Businesses' cost of borrowing¹⁰



Source: European Central Bank, EMF-ECBC

These two major lines of development (on-balance sheet and risk sharing) could be implemented through a bottom-up approach, which would aim at amending the current legislative frameworks by adopting common definitions, risk parameters and market best practices (even if this may be implemented *de facto* through different legal options/solutions at national level). This combination of common European guidelines, flexibility and adaptability in the implementation at national level should ensure a smooth adoption of this structure in what remains a heterogeneous market, as well as supervisory and legislative landscape.

a) On-Balance Sheet European Secured Note (ESN) – Looking at Covered Bond Funding Techniques

The “on-balance sheet ESN” would, as mentioned above, be similar in structure to a covered bond. As such, it could have the obvious advantage of benefiting from regulatory recognition, thus providing the issuer with an additional tool to fulfil liquidity requirements such as the Liquidity Coverage Requirement (LCR). In fact, the transformation of SME loans into an ESN would improve the regulatory and prudential treatment of such assets, by making the bond UCITS¹¹ compliant, and therefore exempt from bail-in, and eligible for a number of prudential and regulatory requirements, such as under Solvency II. In this context, two elements are necessary in order for the ESN to successfully play this role: (i) there must be a robust legal framework around the creation of such an instrument; and (ii) there must be a sufficiently high level of transparency regarding the asset pool.

¹⁰http://sdw.ecb.europa.eu/browseSelection.do?DATASET=0&DATASET=1&DATASET=2&DATASET=3&BS_COUNT_SECTOR=2240&node=9613587
¹¹ http://ec.europa.eu/finance/investment/ucits-directive/index_en.htm

The existence of a legal and supervisory framework is one of the major strengths of covered bonds. This should also be developed for on-balance sheet ESNs, whereby the asset pool would have to fulfil specific criteria. These include, but are not limited to: a harmonised definition of which SME loans are to be allowed as collateral; clear rules on the segregation of the pool for the safety of the investor; appropriate levels of over-collateralisation (OC); and clear *pari-passu* priority claims of the investor to the issuer's assets in the case of default and insufficiency of the pool to cover the value of the bond.

In addition, the eligibility criteria for SME loans need to be developed. A good starting point for this may be the European Central Bank's (ECB) collateral framework, which allows the use of credit claims as collateral for repo operations¹². This alignment would ensure greater marketability and liquidity of the ESN. The second requirement, i.e. transparency, is very much linked to this point, as it is a necessary condition for the accurate assessment of the true underlying risk of the SME assets used in the pool. High levels of transparency would facilitate due diligence and allow investors to effectively understand the underlying risk. However, more importantly, it would allow issuers to effectively manage their portfolio. Therefore, it is of paramount importance to develop an effective transparency framework, which would entail a close cooperation with the SMEs whose loans are included in the pool.

b) Risk Sharing European Secured Note (ESN) – Looking at High Quality Securitisation Techniques

This ESN structure would provide benefits to both the issuer and the investor which would share some risks and be remunerated accordingly. It could offer both funding and some capital relief to the issuer, which would thereby be able to use freed-up capital for additional lending; this would also have the advantage of lowering capital requirements. For the investor, this ESN structure, while maintaining the alignment of interests between originator and investors, would potentially be more interesting in terms of yield, which is a central aspect in the current environment of extremely low interest rates.

As mentioned above, this alternative ESN structure would, in some respects, have analogies with the securitisation techniques in the sense that the assets used in the pool would be transferred to an SPV via true sale or pledged using, for example, the collateral directive (to prevent the need of a true sale at closing). In this case, as for traditional securitisation, the pool could either remain static or have a replenishment period of a few years maximum, which would represent a difference *vis-à-vis* traditional covered bonds where the pool is dynamic (which would also be a characteristic of the "on-balance sheet ESN") throughout the life of the covered bond programme. In fact, the dual recourse principle would apply in this case, though in a different way to that described above for the "on-balance sheet ESN".

As with traditional securitisation, this second ESN structure would be tranching and each tranche would be secured by the portfolio of SME credit claims. Two basic general principles should be satisfied: (i) The originator must comply with the retention requirements ("skin in the game") by either retaining the junior tranche, at least 5% of each tranche or a 5% portfolio of similar risk on its balance sheet; and (ii) public/international institutions could play a role in investing in or in guaranteeing some tranches (senior to equity) of the security in the spirit of promoting the development of the securitisation market and the financing of the real economy through SMEs.

Following this logic, one possible example of a design for this kind of instrument would be one where the originator (issuer), and/or another highly-rated financial institution, guarantees the

¹² <https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp148.pdf>

senior tranche of the ESN. The equity tranche could be guaranteed by institutions such as the European Investment Bank Group (EIB Group, in particular the European Investment Fund); the mezzanine tranche could be guaranteed by government-owned development banks (such as KfW Development Bank in Germany, Cassa Depositi e Prestiti (CDP) in Italy, Instituto de Crédito Oficial (ICO) in Spain or Caisse des Dépôts et Consignations (CDC) in France), again, to encourage public involvement and the sponsoring of securitisation as a means of financing the real economy.

This ESN structure could, through its features, aim at tackling the fragmentation of EU capital markets, and encourage a cross-border market for SME financing throughout the Union. Moreover, the legal safeguards and flexibility of using an on-balance sheet approach and/or risk sharing techniques would reduce the pro-cyclicality of the ESN instrument, thus rendering it especially useful in enhancing the resilience of long-term financing in times of crisis.

It is important to note that, as for the “on-balance sheet ESN”, the “risk sharing ESN” would need to rely on robust transparency requirements, as well as a legal framework to safeguard investors and issuers. In addition, this ESN structure would also depend on the willingness of such international/public institutions to support the instrument through guarantees. Nonetheless, there is a clear intention by EU and national authorities to support the securitisation market, as well as the financing of the real economy and SMEs. Of course, it is pivotal that the risks involved are accurately identified, standardised and mitigated where necessary. This is a *conditio sine qua non* for the involvement of other parties in these transactions.

4. The Way Forward: the Role of Institutions and the Market

Looking ahead, therefore, the success of these instruments would rely on both a robust legal framework and a high level of transparency regarding the underlying assets. The latter, as mentioned above, should be achieved through close cooperation with the SMEs whose loans appear in the cover pools. In addition to this, the development of centralised credit registers¹³ with harmonised levels of information would provide the ideal tool for the achievement of full transparency (while complying with confidentiality laws), and the subsequent increased level of security of these ESNs. All parties involved would be able to accurately assess risks and thereby differentiate their portfolios accordingly, contributing to the quality of the instruments. This links closely to the other condition, i.e. a robust legal framework, which among other things would focus on determining which assets can be used as collateral. Having transparent information regarding these SME loans is a central aspect of this issue.

The ECBC welcomes the enhancement of standardisation and comparability of SME data disclosures at European level. Several instruments and initiatives could facilitate investors' due diligences potentially broadening the investor basis for SME loans.

Inter alia, EU central banks could consider publishing a comprehensive breakdown of SME data, as certain central banks are already doing, which could include, for example, default rates by industry and geographical area. Other avenues to be considered could be credit registers or scoring initiatives such as the Analytical Credit Dataset (AnaCredit), being developed by the European Central Bank, which aim to be a multipurpose set of harmonised confidential granular data on credit and credit risk, and which has the potential to serve many different uses, e.g. supervision, financial stability, monetary policy or risk management.

Any such work on the micro-foundation of, for example, SME loans would represent a significant step forward – as, while efforts are being made by different central banks and market players, currently there is a lack in terms of

¹³ One example of this could be the Analytical Credit Dataset (AnaCredit) “The development of a steady state approach for an analytical credit dataset will continue in 2015 in close collaboration with the FSC. This entails drafting a new ECB regulation and guideline for the collection of granular credit data and the development of an IT tool for data collection, maintenance and dissemination.”, source: http://www.ecb.europa.eu/stats/pdf/2015_ESCB_statistics_work_programme.pdf?ef1338e0f89fd91d3fd02f033aad73a6.

standardisation of information disclosure and SME datasets across the EU - and would allow initiatives like the one proposed in this response to thrive.

A similar approach could also be adopted in the EU to facilitate cross-border data sharing by private organisations. The cross border data exchange could be admitted via a private third party, e.g. Credit Reporting Service Providers (CRSPs), thereby avoiding unjustified restrictions on availability of and data sharing by various types of investors.

Moreover, the issuer community should work together to develop common eligibility criteria for assets (which could be inspired by the ECB collateral eligibility criteria for credit claims as well as EIB Group activity). Establishing a pan-European standard in terms of securities backed by SME or infrastructure loans would be a cornerstone of the strength of this product. Institutions and regulators would also have an important role to play in this context. For example, finance ministries would have to create new regulatory frameworks, or amend existing laws governing securitisation. Furthermore, legislators would have to clearly position these new asset classes within the regulatory and prudential framework by specifying how they would be treated under different regulatory requirements, as well as whether any further criteria would need to be fulfilled. This approach could be reproduced for other capital market instruments as well.

In summary, the way forward depends on both the institutional side as well as the market. The main roles these two parties must play are the following:

Institutional Side (ideally supported by the European Commission):

- Establish an Advisory Council acting as a discussion forum for finance ministries, central banks, potential sponsors and investors.
- Work on micro-foundations, e.g. on clear definitions on SME categories or on criteria for infrastructure loans.
- Create a common legal framework for the new instruments (or amend existing laws). For example, by expanding the collateral directive and allowing it to be used for SME loans.
- Provide support for the “risk sharing ESN” by guaranteeing the non-senior tranches of the security.
- Create common SME loans registers (in co-operation with relevant market participants).

Market Side:

- Create common eligibility guidelines for cover assets.
- Set up a committee on asset transparency.
- Create common credit registers (in co-operation with relevant institutions).
- Establish and develop a specific governance platform and quantitative database inspired by the design, experience and success of the Covered Bond Label.
- This potential market platform should provide full comparability and transparency using the same format and definitions at European level in three areas (cover assets, liabilities and legislative framework) with the ultimate aim of facilitating market participants’ due diligence and reducing reliance on rating agencies.

Concluding Remarks

In conclusion, as a response to the call of Commissioner Hill to gather ideas and market intelligence through the Green Paper on Building a Capital Markets Union, and in order to develop better regulation by means of market initiatives that can support growth and lending to the real economy, in its role as market catalyst the ECBC remains at the complete disposal of the European Commission, to assist and support the development of any market initiative going forward. We believe that private sector stakeholders could play an even more crucial role in financing growth and the real economy if they were put in the condition that would allow them to both take risks and price them by using pan-European market platforms able to provide the basis for a proper cross border market analysis.

PART II: MAIN FINDINGS OF THE ECBC TASK FORCE ON LONG-TERM FINANCING

The ECBC established a Task Force on Long-Term Financing (LTF) at the end of 2014 gathering 20 market experts from 11 different countries with international expertise on long-term financing best practices and techniques. The objective of this group was to analyse and map the state of play of current initiatives on SME & long-term financing solutions at EU level, and to investigate any current or potential interest from/intentions of national and European legislators to use covered bond funding techniques as a model for dual recourse instruments with new collateral asset classes.

The work presented below is the product of constructive discussions among the members of the Task Force, which met in Brussels in January and February 2015 to exchange views with regards to the respective topics assigned to their work streams. In addition, during the last meeting in February, members of the Task Force also received feedback from external stakeholders (Covered Bond Label Advisory Council¹⁴ and multiple authorities working in the domain of long-term financing¹⁵). The feedback received during this last meeting is incorporated in this text.

As a matter of background information, the assigned topics per Work Stream (WS) were as follows:

- **Work Stream I:** Identification of core common macro-prudential and legal characteristics of dual recourse instruments in order to secure bondholders and other creditors of the issuing institution.
- **Work Stream II:** Mapping of current interest and developments in the implementation of other collateral in dual recourse instruments.
- **Work Stream III:** Analysis of investors' needs and perspectives, including the identification of transparency and risk assessment parameters.
- **Work Stream IV:** Definition and analysis of a potential European toolkit for a dual recourse funding model implementable at national level, in particular analysing the issuer's perspective identifying potential blocking factors.

1. Work Stream I: Identification of core common macro-prudential and legal characteristics of dual recourse instruments in order to secure bondholders and other creditors of the issuing institution

WS I Coordinator: Friedrich Luithlen - DZ Bank / Peter Voisey - Clifford Chance LLP

Members of WS I:

1. Gavin Purtill - Banking & Payments Federation Ireland
2. Jens Valdemar Krenchel - Association of Danish Mortgage Banks
3. Wolfgang Kälberer - Association of German Pfandbrief Banks

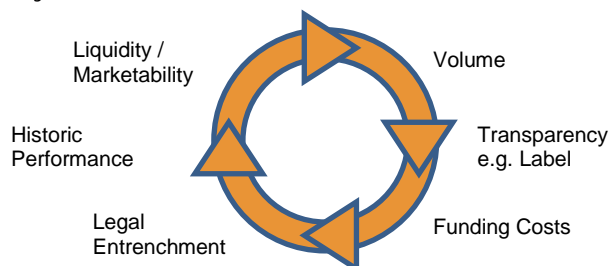
Below, we list the common legal and macro-prudential characteristics of dual recourse funding instruments in the market. From this list, we will develop a recommendation for the legal entrenchment of a dual recourse funding instrument as one necessary condition to create a successful additional dual recourse refinancing tool that can fulfil macro-prudential applications.

¹⁴ <https://www.coveredbondlabel.com/governance-advisory-council>

¹⁵ This meeting was attended by representatives of the European Commission, European Central Bank, European Banking Authority, European Bank for Reconstruction and Development, European Investment Fund, International Monetary Fund, Banco de España, Bank of England, Banque de France, BAFin, Council of the European Union, Danish Financial Supervisory Authority and Financial Conduct Authority (UK), amongst others. For the complete list of attendees, please visit: <http://ecbc.hypo.org/Objects/9/files/DRAFT-LTF-CMU-Panel-Discussion-Programme.pdf>.

Figure 1: Facilitators of macro-prudential applicability

There are six key facilitators for the good equilibrium that allows dual recourse instruments to be used as a macro-prudential policy tool:



In order to emulate the macro-prudential applicability *ex ante*, an obvious starting point is the new product's legal entrenchment. This will serve as a necessary condition to induce low funding costs, significant volumes, sustainable marketability and historic performance.

Dual recourse funding instruments in Europe consist mainly of covered bonds. They are currently characterised by three deciding features:

- Investors have a *pari-passu* claim on the general estate of the issuer and a preferential claim on a special estate.
- Investments in covered bonds are supported by LCR rules, preferential risk-weighting (CRR) and ECB repo-eligibility.
- Finally, investors take comfort from a legal status and special supervision of the product as well as the bank status of the issuer. This degree of legislative / official support for covered bonds means that investors are prepared to accept lower funding spreads on the covered bond product, thereby increasing the issuance volume and market significantly.

The role of covered bonds in the long-term financing of European housing markets and the public sector has been historically an *ex-post* product of a private market initiative.

Currently, covered bonds as the main dual recourse funding instrument are used in three macro prudential fields of application:

- They are a liquidity management tool for banks (Liquidity Coverage Requirement (LCR) & Net Stable Funding Ratio (NSFR)).
- They are used as a monetary transmission tool by the ECB (Covered Bond Purchase Programme 3 (CBPP3)).
- They channel long-term financing into specific areas of the economy.

In order to establish *ex ante* a new dual recourse funding instrument that carries tangible potential for use as a macro-prudential policy tool, we see the legal entrenchment as a necessary condition to create a critical volume in the dual recourse funding instrument.

That said, the micro-prudential challenge remains to create common underwriting, acceleration and reporting standards of the respective loan product. This may well prove another necessary condition to create a vibrant pan-European market for a new dual recourse funding asset class. This relates back to other considerations around civil legislation (acceleration of loans, insolvency rules etc.).

2. Work Stream II: Mapping of current interest and developments in the implementation of other collateral in dual recourse instruments

WS II Coordinator: Frank Will - HSBC

Members of WS II:

1. Anne Caris - Bank of America Merrill Lynch
2. Martin Wigforss - Nordea
3. Matthias Achilles - Luxembourg Bankers' Association
4. Thomas Cohrs - Nord/LB

a) Key Messages

- Strong encouragement from the European authorities to expand into new collateral classes.
- Already development of new products in several countries (law-based or structured) either under the brand name "covered bond" or as dual recourse funding instruments.
- Lack of supply due to a mixed set of reasons.
- Investor demand mixed; investor education needed.
- New dual recourse funding instruments do not benefit from the same preferential treatment as covered bonds.
- Regulatory obstacles.
- Securitisation often better suited.
- Financing via state-guaranteed agencies often cheaper.
- Trade-off between "relying on traditional collateral" and "expanding the importance of asset class".

b) Country Overview I

Country	Name of instrument	Eligible Assets	Issuers	UCITS	Development potential ¹		Outst. Amount
Germany	Ship Pfandbriefe	Loans secured by ship mortgages*	Bremer LB, Commerzbank, DVB, HSH, NORD/LB (old: MM Warburg)	Yes	Market peaked in 2008 at €9.3bn; new benchmark in Feb 2015	0	€5.2bn (Sep 2014)
	Aircraft Pfandbriefe	Loans secured by aircraft mortgages*	Only NORD/LB	Yes	Market only started in 2012	+	€1bn (Dec 2014)
	Structured Covered Bonds	Any loan type secured or guaranteed	Only Commerzbank (old: LBB and Valovis)	No	Market only started in 2013	+	€0.5bn (Dec 2014)
Luxembg.	Lettres de Gage Mobilières	Movable assets (mortgage loans on ships, aircrafts, trains or other classes of movable assets)**	None so far	Yes	Law change was already back in 2008	0	No issuance
	Lettres de Gage Mutuelles	Exposures to credit institutions in the EEA/ OECD which are members of a system of mutual guarantees	None so far	Yes	Law change was in 2013	0	No issuance
	Lettres de Gage Publiques	Obligation from public sector institutions (wide definition incl. public private partnerships (PPP))***	Dexia LdG Banque, EEPK, HPI, NORD/LB CFB, SocGen	Yes	Market peaked in 2008 at €35bn	0	€22bn (Dec 2013)

*LTV of 60%, only instalment loans, insurance required, no longer than 20 years.

** Movable assets and the charges on the property of those assets need to be registered in a public register.

*** Provided a controlling public sector stake.

1 ++ strong growth potential, + growth potential, 0 neutral, - shrinking market, -- fast shrinking market.

c) Country Overview II

Country	Name of instrument	Eligible Assets	Issuer	UCITS	Development potential ¹		Outst. Amount
France	Euro Secured Notes (sector initiative; not under legal framework)	SME loans (eligibility criteria matches Eurosystem's)	Major French banks part of the project include BNPP, BPCE, ACAFP, HSBC, SocGen	No	Material given importance of SME sector in France	+	€3.2bn (privately placed)
Denmark	Ship covered bonds	Loans secured by ship mortgages	Only Danish Ship Finance	Yes	Market shrinks	-	DKK 45bn (Q2 14)
Cyprus	Ship covered bonds	Loans secured by ship mortgages	None so far	Yes	We don't see huge growth potential	0	No issuance
Austria	Austrian covered bonds	Plans to expand rules on eligible collateral	None so far	Yes*	Neutral growth potential	0/+	No issuance
Italy	Obbligazioni Bancarie Collateralizzate (OBC ≠ OBG)	SME loans, corporate bonds, commercial paper, shipping loans, lease and factoring receivables, ABS tranches backed by the above assets	None so far	n/a**	Material given importance of SME sector in Italy (new law in Feb 2014)	+	No issuance

* Expected ** depends on the final regulation.

1 ++ strong growth potential, + growth potential, 0 neutral, - shrinking market, -- fast shrinking market.

d) Country Overview III

Country	Name of instrument	Eligible Assets	Issuer	UCITS	Development potential ¹		Outst. Amount
Spain	New Spanish securitisation law allows for structured CBs	Any type of loan, secured or not, such as SME or corporate loans or bonds	None so far	No	Material given importance of SME sector in Spain	+	No issuance
	• Cédulas de Internacionalización (CI) • Bonds de Internacionalización (BI)	• Export finance assets with state guarantee/ insurance (CI & BI) • Also Private sector export companies w/o state guarantee/ insurance (BI)	n/a	Yes	Neutral growth potential	0	n/a
Netherlands	Dutch covered bonds (new law in 2015)	• Ship mortgage loans • SME loans might be introduced at a later stage	None so far	Yes	We don't see huge growth potential	0	No issuance
Turkey	Turkish SME covered bonds	SME loans	Sekerbank, Yapi Kredi Bankasi, Denizbank	No	Inaugural deal in 2011; mainly private placements to S&A*	0/+	Slowly growing

* Mainly private placements with FMO, IFC, EIB, EIF, EBRD, KfW, but also some private investors; Sekerbank to launch first public deal; 1 ++ strong growth potential, + growth potential, 0 neutral, - shrinking market, -- fast shrinking market

e) Country Overview IV – Nordic Region

- Ship covered bonds in Denmark (only Danish Ship Finance).
- Otherwise none of the four Nordic countries (DK, Finland, Norway and Sweden) currently include "other collateral" (e.g. ship/aircraft/SME loans) as eligible.
- No initiative in any of the four Nordic countries for expanding the covered bond product, rather strong preference to keep the current collateral rules.
- General political desire to facilitate financing of the "real economy":
 - Focus on corporate and high yield bond markets
 - Initiatives to develop of these markets (bond trustee in DK and development of standard bond terms by trade associations in DK, Finland and Sweden)

- Crowd funding platforms (very small)
- But no new dual recourse instruments
- Recent law changes in Denmark facilitate the securitisation of loan portfolios by introducing a register for securitised assets held by the originator, as an alternative to a borrower notification.
 - However, still true sale securitisation and not dual recourse funding instrument.

f) Low Supply of “Other Collateral Instruments”

What have been the reasons for the relatively low supply of dual recourse funding instruments backed by other collateral?

- Lack of investor demand (regulatory treatment, lack of understanding, “wrong” assets).
- Regulatory issues (risk weighting under CRR, Solvency II, LCR, ECB repo eligibility).
- Rating agencies’ concerns.
- Lack of eligible assets.
- Asset encumbrance problematic.
- Cheap senior unsecured funding.
- Low overall funding needs due to lack of loan demand, (T)LTROs, deleveraging.
- Often securitisation better suited.
- Competition from agencies (KfW, Rentenbank, L-Bank, NRW.BANK, ICO etc.).
- Collaboration with supras & agencies (Turkish SME covered bonds, German public sector Pfandbriefe).

3. Work Stream III: Analysis of investors’ needs and perspectives, including the identification of transparency and risk assessment parameters

WS III Coordinator: Massimo Bianchi - Société Générale / Florian Eichert - Crédit Agricole

Members of WS III:

1. Alcyme Delannoy - Crédit Foncier de France
2. Danielle Boerendans - Dutch Association of Covered Bond Issuers
3. Torsten Schmidt - TXS

In order to deliver this analysis, the members of Work Stream III elaborated a survey to distribute to relevant covered bond investors. The survey discussed the conditions of the hypothetical implementation of a new dual recourse funding instrument, focusing on both its potential structure and collateral. In the end, seven high quality investors amongst the most active European investors on the covered bond market granted their answers to the questionnaire.

Although the survey results clearly point out that investors think there is undisputable room for innovation on the covered bond market, the survey has also emphasised the investors’ preference for standardisation on structuring, monitoring and reporting. Most investors tend to favour harmonisation on the market with law-based instruments rather than contractual, arguing that innovation would require more pool information and a premium. With a clear preference for granularity and homogeneity of the covered pools, investors’ minds are open to face non-traditional collateral (from SME and shipping to infrastructure finance and potentially non-performing loans) should an adequate information package be provided, clearly searching for yield in such an environment. On the reporting side, a majority of the investors surveyed (71%) were keen to leave the required investor report at the same frequency (quarterly) as for traditional covered bond products.

We can foresee some emerging trends leaving space for innovative features and non-traditional credit pools.

- The Conditional Pass-Through structure is seen as an improvement for 71% of the investors surveyed in the market, although it is not expected to become a market standard.
- The homogeneity of the cover pool is still a key driver but a significant number of investors have indicated that it is not a requirement anymore.
- Investors seem ready for new structures and non-traditional collaterals if a number of conditions are met: strong information packages are needed (loan-by-loan, monthly or quarterly reporting etc.) to comply with their internal credit analysis; and an adequate pricing rationale, including a premium vs. traditional covered bond instruments, to compensate for the additional complexity.

All-in-all, investors are eager to preserve the dual recourse framework while implementing new structural or collateral features.

On the one hand, it has been remarked that some issuers have a preference to keep the Covered Bond Label for very standardised products while opening to a new denomination for innovative structures and non-traditional cover pools. On the other hand, it appears clear that investors need to have at their disposal a complete set of comparable informative packages in order to facilitate monitoring procedures and pricing rational, and to open up to a new generation of dual recourse investment products.

In this low yield environment, investors acknowledge the need for innovation on the covered bond market in order to satisfy their appetite for yield and are open in many ways to hybrid asset classes (with the ABS market) but not do not wish to give up to the dual recourse principle: this is a very important background for “a product innovation” cycle that could enlarge the market volumes size of the only funding product that proved to be resilient during the last financial crisis, for the benefit of the European banking system.

a) Questions and Results of Investor Survey:

		Statistics	Comments and Analysis
A. About the Structure	I. A new instrument for dual recourse instruments	Yes: 100% No: 0%	<ul style="list-style-type: none"> ▪ Undisputable room for innovation ▪ No collateral mix ▪ Suggested collaterals: SME, microfinance... ▪ Different pricing rationales vs. traditional Covered bond
	II. Which buying center?	Combination of teams: 43% ABS team: 14% Covered bond team: 14% N/A: 29%	<ul style="list-style-type: none"> ▪ Preference with a combination of teams at 43% (ABS + Covered bond team suggested at 29%) ▪ Credit analysis: performed by sector specialists ▪ Portfolio managers: depending on internal organization
	III. "By-law" preference?	Favourable: 86% No: 14%	<ul style="list-style-type: none"> ▪ Most investors are in favor of a new instrument regulated by a covered bond law
	IV. Should "contractual" mimic "by-law"?	Standard structure: 71% Open to different structures: 57%	<ul style="list-style-type: none"> ▪ Strong trend towards harmonization of the Covered bond market, yet there is some space for innovation ▪ A non standard structure would require more pool information and a premium
	V. Large sole pool vs. multiple pools with concentrated assets?	One large pool: 71% Multiple pools: 43%	<ul style="list-style-type: none"> ▪ Multiple pools are accepted when homogeneous
	VI. Conditional Pass-Through seen by investors	<div style="display: flex; justify-content: space-around;"> <div> <p>Improvement</p> <p>Yes: 71% No: 14% N/A: 14%</p> </div> <div> <p>Standardization</p> <p>Yes: 43% No: 43% N/A: 14%</p> </div> </div>	<ul style="list-style-type: none"> ▪ CPT is not foreseen to be a standard instrument but more volume is expected due to rating benefit

		Statistics	Comments and Analysis
B. About the Collateral	I. Is granularity still a must?	<ul style="list-style-type: none"> High level of granularity preferred: 86% Loan by loan analysis accepted: 57% 	<ul style="list-style-type: none"> Clear preference for granularity
	II. Is homogeneity still a must?	<ul style="list-style-type: none"> Homogeneity of assets: 57% Open to mixed assets: 43% 	<ul style="list-style-type: none"> Homogeneity is a key driver but not a requirement anymore Open to loan-by-loan if adequate disclosure and premium paid
	III. Is loan-by-loan information a requirement for innovative asset pools?	<ul style="list-style-type: none"> Yes: 43% No: 43% N/A: 14% 	<ul style="list-style-type: none"> Not required but helpful on a name-by-name basis
	IV. Is loan-by-loan information a determinant factor in investment decision?	<ul style="list-style-type: none"> Buy both: 43% Buy dual recourse instrument: 29% Buy Senior ABS tranche: 29% 	<ul style="list-style-type: none"> Some investors do not consider loan-by-loan information in arbitraging ABS and Covered bonds because of: <ul style="list-style-type: none"> Regulatory issues Portfolio managers investing in ABS and Covered bonds are two different teams
	V. Investor report frequency	<ul style="list-style-type: none"> Quarterly cover pool data: 71% Monthly cover pool data: 29% 	<ul style="list-style-type: none"> Higher (monthly) or same (quarterly) frequency than for traditional Covered bond products
	VI. Issuer buying protection on first/second loss to public or private entities	<ul style="list-style-type: none"> Yes: 71% No: 0% N/A: 29% 	<ul style="list-style-type: none"> All investors who answered the questionnaire accept the proposition Some expressed concerns about a further layer of counterparty risk while other see it as an additional protection to the cover pool

4. Work Stream IV: Definition and analysis of a potential European toolkit for dual recourse funding model implementable at national level, in particular analysing the issuer's perspective identifying potential blocking factors

WS IV Coordinator: Paolo Cancellaro - Intesa Sanpaolo / Boudewijn Dierick - BNP Paribas

Members of WS IV:

1. Katarzyna Kappeller - Pfandbrief & Covered Bond Forum Austria
2. Kim Laustsen - Nykredit
3. Matthias Achilles - Luxembourg Bankers' Association

Additional contributors: Mauro Menzio - Intesa Sanpaolo and Luciano Chiarelli - UniCredit

a) Key Message – Pillars

In principle, various dual recourse options are feasible, most likely requiring changes in current legal frameworks. The pivotal point is the shift of the obligation on the asset's pool following the event of the issuer's default: from this perspective, a banking issuer would result in the most robust option, paving the way to the relative value comparison vs. covered bonds.

From a technical perspective, dual recourse bonds could be issued by a SPV issuer as well. In both cases, the "Multiple Funding Structures" would result in structures viable to smaller originators (e.g. French Euro Secured Notes Issuer, ESNI) even if transparency and segregation topics should be addressed, adding further legal constraints.

b) Common Main Features of a Successful Structure

In spite of the nature of the issuer, common main features of a successful structure can be summarised as follows:

- Legal framework also with strong bankruptcy remoteness of the segregated assets.
- Dual recourse on homogeneous and dynamic segregated assets with a robust internal/external monitoring process.
- High degree of transparency on structure, assets and clear allocation of roles (in pathological scenario, too).
- Capability to ensure some capital relief.

c) Conversely, Blocking Factors to Avoid...

- Assets' eligibility criteria either too strict or too loose: the right balance has to be defined between legal and contractual levels.
- Limited/insufficient commitment by the local national supervisor.
- Weak or relaxed set-up in some sensitive topics for rating agencies and investors (ALM & liquidity management requirements, vagueness on post default structure functioning and supervisory).
- Low product differentiation vs. covered bonds; a new and common name would help.

d) ...and Further Desirable Features: Liquidity/Prudential Treatment

- The product should be eligible for national central banks' (NCBs) refinancing operations, eligible for LCR and NSFR, and should be admitted to a preferential treatment for investors: regulators are expected to set appropriate levels vs. covered bonds.
- The product should not be bail-in-able.

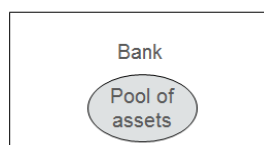
e) Potential Structures, At a Glance

i) On-balance-sheet ESNs:

1. Classic Direct On-Balance Issuance: bonds are issued by a bank without the transfer of the assets to an external entity. The assets are segregated through a pledge/register/specialised banking and the dual recourse is direct. Could require substantial changes to bankruptcy and security law in some jurisdictions; in addition, segregation of assets and swaps could not be possible in some jurisdictions.

Potential Structures (1/7) Classic Direct On-balance Issuance

Used for CBs in Germany, Spain, Denmark, Cyprus, Belgium



Key characteristics

- Issuer of bond is a bank
- Double recourse to bank and segregated assets
- Specific register or pledge on pool of assets
- Assets segregated in case of insolvency (use of collateral directive?)
- Investors should have preferential claim over pool

Implications

Bank issuing bonds and asset segregation on-balance

Advantages

- Simple structure, easy to understand (comparable to CBs)
- No need to transfer assets to a different entity
- Direct double recourse
- Specialized bank structure can solve potential disadvantages, cf. below (e.g. Danish specialized mortgage banks)

Potential disadvantages

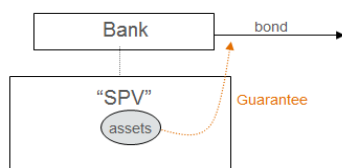
- Could require substantial changes to bankruptcy, security law in order to avoid challenges from other creditors and conflict with existing negative pledges if collateral directive or other ways cannot be used
- Segregation of assets and swaps on-balance may not be possible in certain countries in current legal set up

2. On-balance Issuance with Separate Guarantor: bonds are issued by the bank while assets are transferred to a separate legal entity that guarantees the bonds 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 exposure. The guarantee provided by the special purpose vehicle (SPV) implies the dual recourse.

Potential Structures (2/7)

On-balance Issuance with Separate Guarantor

Similar to CB structures as used in Italy, the Netherlands, UK, Canada, NZ, Australia



Can be used in many countries

- Similar to CB-structures that were developed before CB-law existed in various countries (e.g. UK)
- Used when existing law allows transfer of assets using securitisation technologies effectively (e.g. Italy)

Implications

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

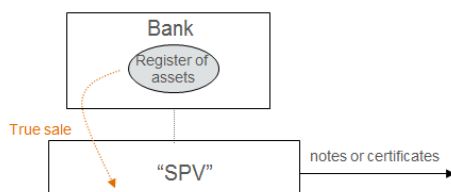
- Similar to CB structures in Italy, NL, UK
- Assets transferred to legally separate entity
- Separate entity/ SPV will need to be able to provide guarantee legally
- Most activities remain at Bank (Issuer/Originator) level
- Regulatory limits on intra-company exposure typically need to be addressed by the existing law

3. Issuance by SPV with True Sale of Assets from Bank: 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). This structure requires clear segregation of the assets (regulated by bankruptcy law) debtors' set-off rights need to be addressed in the event of the bank's default.

Potential Structures (3/7)

Issuance by SPV with True Sale of Assets from Bank

Similar to German 'Refinanzierungsregister' or Danish 'Corporate Loan Refinancing Register'



- Bank register of assets sold to SPV – the SPV issues bonds or certificates
- Entry into the Register effectively segregates the sold assets from other assets of the Bank in the event of the Bank's bankruptcy
- Double recourse to SPV and segregated assets in bank (via true sale) in the event of the Bank's bankruptcy

Implications

SPV owns dynamic pool of assets maintained by the bank and issues bonds or certificates

Advantages

- SPV is a separate legal entity
- External supervision of register (auditor or trustee) – FSA-license to keep bank registers
- De facto dynamic legal transfer of segregated assets to SPV – however bank maintains assets in dynamic register
- Similar to true sale ABS in the event of the bank's bankruptcy: assets are truly sold, i.e. current assets in register are automatically transferred to the SPV or a new register (i.e. another licensed bank chosen by the SPV). No "bail-in" issue.

Potential disadvantages

- Requires clear identification of possible assets in register / clear segregation of assets (e.g. regulated by bankruptcy law)
- Debtor's set-off rights against the bank in the event of bankruptcy needs to be addressed

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.

Potential Structures (4/7)

Issuance by SPV with Guarantee from Bank

Issuance by SPV with guarantee from bank



Implications

Separate legal entity/SPV owning assets and issuing Bonds

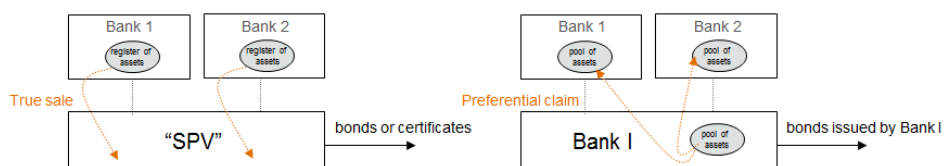
- SPV is separate legal entity
- Supervision, license of SPV?
- Legal transfer of assets to SPV (securitisation techniques)
- Activities outsourced to parent
- No automatic double recourse: guarantee or specific support from parent to investors needed

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.

Potential Structure (5/7)

Multiple Bank Funding Structures: Scaling issuance

Examples



Implications

Multiple Bank joint funding structures – scaling basic structures

Advantages

- Economics of scale
- Small banks gets access to capital markets funding, i.e. retail/SME gets access to competitive capital markets funding
- Improving liquidity of issued bonds

Potential Disadvantages

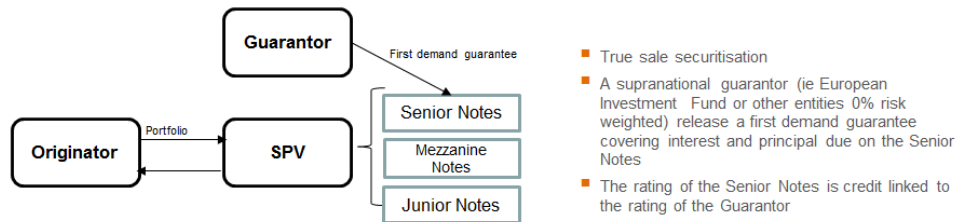
- Lack of transparency of all underlying assets – regulation of transparency requirements
- Segregation of assets and access to assets in "underlying" banks (via true sale or preferential claim) need to be addressed in order to avoid challenges from other creditors or bail in (i.e. bankruptcy law / BRRD implementation) – may be only possible for non-deposit taking specialised banks

ii) Risk Sharing ESNs:

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.

Potential Structures (6/7)
ABS guaranteed

Dual recourse structure: 1st on the segregated pool of assets, 2nd on the guarantor



- True sale securitisation
- A supranational guarantor (ie European Investment Fund or other entities 0% risk weighted) release a first demand guarantee covering interest and principal due on the Senior Notes
- The rating of the Senior Notes is credit linked to the rating of the Guarantor

Implications

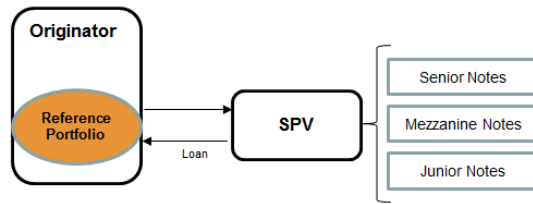
Advantages

- Dual recourse structure
- Investors will benefit by the well-known securitisation framework
- No major changes needed in the current regulatory framework
- Potential capital relief purpose
- The Senior Notes can be placed to investors and are expected to be REPO eligible with the Eurosystem/bilateral financing
- Tranching is function of a double analysis level with the attachment point of the guarantee set by the Guarantor analysis affecting the rating agencies assessment on the portfolio
- **Potential disadvantages**
- Few guarantors meeting the criteria
- Limited amount of volume of guarantees

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.

Potential Structures (7/7)

ABS backed by a limited recourse loan



- An SPV disburses a limited recourse loan to the originator
- The payment of interest and principal on the loan is limited recourse on the cash flows collected on a reference portfolio
- The SPV raises the funds through the issuance of three classes of notes placed to institutional investors

Implications

Advantages

- The reference portfolio is not transferred to the SPV
- Plain structure
- Potential capital relief purpose

Potential disadvantages

- Not really dual recourse structure
- In case of default of the Originator, the notes are unsecured (since the Reference Portfolio is still on the Originator's balance sheet); this could have an impact on the maximum achievable rating (to be verified with the rating agencies)
- A change in the legal framework including the segregation of such assets by law it would be desirable
- amendment on securitisation regulatory framework
- Changes to the relevant legal framework could be necessary to ensure the exemption from the bail-in

ANNEX I: CASE STUDY ON SME LENDING DISCLOSURE

Research, risk analysis, cash flows and due diligence can be complemented with loan level data and documentation available, for example, through the European DataWarehouse (ED)¹⁶ and Credit Reporting Service Providers (CRSP)¹⁷. Currently, interested parties can compare SME portfolios on a common platform across the European Economic area jurisdictions. Over time, with the inclusion of performance data for each individual loan, investors will also be able to analyse performance patterns for specific clusters within the respective portfolios.

As highlighted in the European Commission's Green Paper on Capital Markets Union (CMU), widening the investor base for SMEs is a key objective that must be achieved to kick-start the debate on possible measures to create a true single capital market. There are many obstacles which need to be resolved to systematically reduce information asymmetry and its corresponding adverse selection problems. In particular, improving credit information would help build an efficient and sustainable capital market for SMEs.

On the latter point, a mapping exercise has been conducted by the European Commission and is part of the working document *"European Financial Stability and Integration Review"*¹⁸. This is an important step forward that identifies limitations (especially due to national regulatory barriers) in terms of what data can and cannot be provided by CRSPs, and to which interested parties this data can be made available or not. The document also tracks the principles that could shape potential policy actions in order to improve credit information infrastructure. This is one way to potentially make loan level data and all other relevant credit information available across Europe to all interested players, leveraging on already available private infrastructures.

Availability of information for SME securitisations

While for most relevant markets there is relatively good historical performance, loan level data and documentation available, there are currently some limitations when looking at the European Union's SME finance market:

- Data is realistically usable in markets where there are a number of SME asset backed securities (ABS) deals or many underlying loans that are numerically representative for a specific jurisdiction;
- Loan level performance data is recent (as ED only started collecting this information from January 2013 onwards) and, therefore, it will take some time to produce meaningful cluster and historical performance analysis.

Transaction specific information

With the introduction of the European Central Bank reporting template for SME securitisations and the implementation of the Eurosystem reporting requirements for issuers, the availability, comparability and accessibility of information has greatly improved.

More specifically, for new primary market transactions, information requirements are typically available from the originating banks, although the degree of detail can vary significantly across markets and individual originators.

¹⁶European DataWarehouse (ED) is registered in the European Institutions' Transparency Register under ID Number 781559916266-15.

¹⁷European CRSPs are represented by their Association ACCIS, more figures and facts on the website www.accis.eu.

¹⁸http://ec.europa.eu/finance/financial-analysis/docs/efsir/150427-efsir-2014_en.pdf

Depending on the type of transaction (public/private) and the applicable regulatory framework, relevant information might, however, not be accessible for all market participants but rather only for a select group who invest e.g. in mezzanine or first loss position buyers.

For SME securitisations in more mature markets, data availability is arguably sufficient. Nevertheless, some relevant data might not be publicly available, e.g. with respect to the higher regulatory standards currently required for mezzanine or equity investors. A key aspect is that through granular SME portfolios a statistical rather than an individual SME credit approach can be chosen. For markets with no or little SME securitisations, information barriers will continue to be relevant and transactions will be less efficient.

Traditional finance channels have information advantages which make the involvement of non-traditional finance channels more difficult. Available information outside the banking system can be helpful in extending finance to larger SMEs and towards other forms of financing. To materially improve the availability of meaningful data, both in qualitative and quantitative terms, existing available data is being increasingly used to create a working pan-EU data infrastructure for SME finance, one such example is the ED.

Given the fragmentation and complexity of SME finance in Europe, better data infrastructure realistically can only be achieved on a gradual and long-term basis.

Statistics on the SME ABS transactions available in the European DataWarehouse

As of April 2015, a total of 137 SME transactions have been created and uploaded in Edwin, ED's software platform, for a total of 1.3 million loans, or loan parts, across several jurisdictions. The information available on SME loans is consistent with the European Central Bank reference reporting template,¹⁹ including:

- Obligor information;
- Loan characteristics;
- Interest rate;
- Financial information;
- Performance information;
- Bond information.

The information currently present in ED's Edwin is updated on a regular basis, at minimum quarterly, during the life of the transaction. The loan level data is available in a standardised format to all interested parties, including institutional investors, credit rating agencies, data vendors, traders, originators and sponsors.

¹⁹ <https://www.ecb.europa.eu/paym/coll/loanlevel/transmission/html/index.en.html>

Detailed statistics for the SME deals present in ED's Edwin (April 2015)

Detailed statistics for the number of SME loans and loan parts present in ED's Edwin (April 2015)

