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

ESN Task Force

European Secured Notes (ESN) Blueprint

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Contents

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1. Introduction

The European Policy Agenda

In the context of the Capital Markets Union (CMU) Action Plan, 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. These include SMEs' assets, including green and social exposures. This initiative combines existing covered bond techniques and best market practices aimed at establishing 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.

SME financing remains a crucial objective of the EU, as reiterated in the Statement[1] of the Eurogroup on the CMU issued on 11 March 2024, as well as in the *Much More Than A Market* Report[2] issued on 18 April 2024. In this Report, Enrico Letta said: "*The initial priority should be to mobilise private capital, a crucial step that lays the groundwork for a more inclusive and efficient financing framework, as it is the area where the EU is most lagging*." In this context, ESNs would represent an investment opportunity with a dual benefit: higher yields compared to traditional Covered Bonds and direct private investment in the core of the Single Market: SMEs. Moreover, by fully integrating financial services within the Single Market, the Savings and Investments Union aims to not only keep European private savings within the EU but also attract additional resources from abroad.

This project has gained even more importance in the recent inflationary context with rising interest rates which proved challenging for European businesses and even more for SMEs, even more so after the winding down of the TLTRO by the ECB which allowed for many years of affordable SME financing. In this context, ESNs would be used as a multiple-purpose instrument: a recovery tool when the EU economy is under stress, and an instrument to respond to the competitive challenges at the global level for European SMEs, which are mostly export-oriented, as well as leverage to channel ESG investments for SMEs.

From a legislative standpoint, the EBA[3] has been tasked by the European Commission (EC) to provide advice on ESN, for the EC, if appropriate, to take legislative action in this field[4]. Against this background, 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 of the Task Force is to share intelligence and knowledge via different workstreams by defining concrete proposals, providing technical advice, investor education and sharing best practices between the members from the various jurisdictions. The EBA and the EC will ultimately receive the technical analysis and recommendations of the ESN Task Force.

Against this background, the ECBC has set up a dedicated ESN Task Force (TF), which has developed the ESN Blueprint, highlighting the key factors of the ESN product, defining the eligible assets and potential structural features to frame the different possibilities for asset segregation according to the various National legal systems. In particular, the Blueprint has assessed which of the CBD articles would also fit ESN and which would need modifications. After the first publication of the Blueprint in 2021, the TF has re-started its activities as its members see the need for a long-term viable financial tool and the momentum to launch a regulated ESN product. The shift toward tightening the monetary policy has made the importance of this instrument more compelling.

[1] https://www.consilium.europa.eu/en/press/press-releases/2024/03/11/statement-of-the-eurogroup-in-inclusive-format-on-the-future-of-capital-markets-union/

[2] Letta, E. (2024). *Much more than a market*. Available at: https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf

[3] The European Banking Authority in its previous Report on the European Secured Notes published on 24 July 2018, indicated that ESNs might provide a useful additional source of funding for SMEs.

[4] According to the Art. 31(5) of the Covered Bond Directive, the European Commission (EC) has to write a report on ESN and may propose a legislative initiative by 8 July 2024 (likely delayed).

Considerations on Data Disclosure and ESG

The current policy framework sees on the one hand a surge of sustainable disclosure requirements and the still significant push towards more sustainable investment opportunities and initiatives, such as the EU Green Bond Standard, scaling up the sustainability ambition of the continent coupled with the Taxonomy requirements. On the other hand, the geopolitical challenges and the surge of inflation and interest rates have put a significant share of households and SMEs under stress. Against this background, a project such as the ESN is perfectly suited to respond to these ambitions and needs in positioning its focus not only as a 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 for this nascent asset class to be relevant in the future. Indeed, alongside the potential for ESNs to provide support for the real economy, as Latham & Watkins note in their Client Alert Commentary entitled "European Secured Notes: Coming to a Bank Near You?", *"there is potential for SME ESNs to serve as a funding instrument for banks that is aligned with ESG objectives"*[5]. Latham & Watkins suggest that ESNs could, for example, attract a social label, through their focus on funding an economic sector that traditionally faces challenges in accessing credit. As far as the 'green' agenda is concerned, the authors suggest that *"depending on the issuing bank's underwriting strategy, SME ESNs may be welcomed as yet another sustainable finance instrument that could further leverage private capital for ESG aims".* Indeed, improving access to long-term finance for energy efficiency projects is key to achieving the EU's climate targets and, further to recent developments, helping secure the EU's energy independence as rapidly as possible. As a key driver of the real economy, the EU's businesses will be fundamental in supporting the climate transition and meeting these objectives.

In order to be operational it is important to highlight the current lack of 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.

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 for proper information disclosure has also been highlighted by the European Commission (EC) with the recent proposal of the ESAP (European Single Access Point for financial and non-financial information) initiative in the context of the Capital Markets Union Action Plan. ESAP 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, objectives which align perfectly with the ESN initiative

The challenges highlighted above can be addressed with the support of initiatives such as the EU-funded TranspArEEnS Project which is developing an infrastructure, consisting of an SME survey, database and Energy Efficient (EE) -ESG rating designed to enhance the availability of standardised and transparent information on SMEs' EE-ESG credentials, as a complement to information on their financial and economic performance, and therefore support analysis of the credit performance of SME loans. A more robust understanding of the profile of SMEs could make an important contribution to unlocking the potential of ESNs, offering a wide range of benefits for issuers and investors, and of course SMEs through potentially enhanced access to financing.

With these barriers in mind, the ESN project would benefit from the establishment of a harmonised data template to collect information on the SMEs being financed, leveraging on the positive experience from the Harmonised Transparency Template of the Covered Bond Label, which since its debut in 2017 is now used for reporting the underlying cover pool assets of over 75% of the covered bonds outstanding globally and where in 2020 a new ESG specific section has been included in the template. This best practice would act as a blueprint for the ESN TF to establish a similarly harmonised template for SME data with a dedicated ESG section, in collaboration with the investor community in order to capture the relevant data points necessary to assess the credentials, including the EE-ESG credentials, of SME loans in ESN cover pools.

[5] Other important research on ESN are e Study on the Feasibility of European Secured Notes prepared by Richard Kemmish Consulting and published by the European Commission in July 2018. https://www.lw.com/admin/upload/SiteAttachments/Alert%202798.v3.pdf

Mindful of the fact that the work on developing a shared framework for ESN has just begun, this Note is intended to present the results of the ongoing reflections of the TF[6]. The Note is divided into the following three Sections:

1. The Business Case for ESN
2. Further reflections on Eligibility Criteria for a high-quality cover pool
3. Analysis of Structural Features

2. The Business Case for ESN

In these last months, due to the new economic and political conditions, an even stronger business case for ESN has emerged from the reflections of the TF. Indeed, the recent public debate on CMU and the Single Market has highlighted the importance of supporting SME financing, even more importantly as increasing protectionism at the global level is a threat to European SMEs, which are mostly export-oriented.

ESN as a Funding Tool for SME

Further to a 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 of the TF agreed to focus on SME financing rather than infrastructure.
There have been attempts to issue SME-backed dual recourse bonds more than a decade ago but they have not been replicated significantly since then. Today, the situation is different to the extent that SME lending is more relevant than ever and a decisive component of the European recovery, tightly linked to employment and sustainability concerns.

According to the 2022 Eurostat[7], European SMEs employed 84.9 million people in total and produced EUR 3 945 billion of value added or 51.8% of the overall economic contribution in the EU, therefore SMEs continue to represent the backbone of the European economy. In contrast, just 0.2% of all enterprises had 250 or more persons employed and were therefore classified as large enterprises. The latest SAFE survey of the European Central Bank reports that SMEs are increasingly in need of external financing, but are facing an environment of stricter credit conditions showing increasing interest rates and collateral requirements[8]. Therefore, the development of the ESN can complement the strategically important policy objective of supporting both the European recovery capabilities and the SME landscape in line with CMU policy objectives.

Tighter monetary policy causing rising interest rates, the reimbursement of the TLTRO, the progressive winding down of the bond purchase programme by the ECB and the impact of inflation, also on customers' deposits, are certain elements which contribute to the shift in banks' funding needs. It is worthwhile recalling that in an increasingly normalised monetary policy context and after a subdued level of public deals in 2020 and 2021, the annual volume of covered bond issuances reached a new peak in 2023, demonstrating their value and widely ensuring market access to relevant banks. Such market access would be enhanced by ESN as a new dual recourse instrument which, together with CB, would contribute to the overall financial stability.

The importance of a critical mass. 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 2.5 trillion (as of July 2023[9]) reveals substantial. Regular research confirms that bank-related finance still represents the most important financing channel for SMEs 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 of ESN can be identified.
1. The historical risk profile of SMEs
2. Potential mitigating factors (including guarantees provided by institutions such as the EIB).

[6] A first release of the ESN Blueprint was published and presented in April 2021.
[7] most recent figures available taken from the Annual Report on European SMEs 2023
[8] European Central Bank - Survey on the Access to Finance of Enterprises (SAFE), Analytic Report. SAFE has recently been quoted by the European Stability Mechanism (ESM), reporting that SMEs in the Euro Area have been facing greater financial difficulties than large firms 14% reporting financing constraints against 7% for larger Companies
[9] EBA – Risk Assessment Report of the European Banking Authority

3. Policy settings such that the ESN would provide policymakers with a tool to specifically support SMEs in a targeted manner (ideally in a sustainable format, see below).

The combination of the three factors would provide an asset class serving the specific purpose of supporting SMEs, employment, economic growth and the ESG transition, therefore enjoying policy support which in turn reduces the risk cost to issuers and potential ESN investors.

The need for a new long-term refinancing product is especially true in jurisdictions where capital markets need to develop further and, also thanks to the CBD, are exploring their potential use of collateralised tools, which have in comparison more SME loans than residential mortgages to finance. In this context adding the ESN to the existing toolbox would certainly be a positive (i.e. complementarity with CB, securitisation, collateralised lending), also in connection with possible interventions of the EIB/EIF in specific cases.

Does the ESN need to be a regulated instrument or can banks issue ESN-like instruments on their own? Well, despite its evident need, facts have shown that the ESN has not enjoyed so far more appetite in the market, expressly because of the lack of an EU-wide regulatory framework. If we look at the experience in the markets, only very circumscribed issuance of double recourse SME-backed loan instruments took place in the EU, linked to the needs of single banks at a specific point in time. Moreover, the possible use of SME assets as guarantees to Central Banks for collateral funding is limited at the national level and proves to be less efficient for banks in terms of higher haircuts. We therefore advocate that the potential value of ESN to support bank funding and SME finance could be enhanced by a supportive legislative framework.

ESN collateral should be made up principally of SME loans (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[10]. 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 over collateralisation levels without the risk of running out of assets, (ii) is greater than that of residential real estate loans and issuers will need a large base of collateral would compensate the expected level of delinquent and defaulting SME loans, and (iii) in some jurisdictions the outstanding SME loan volumes can be much lower than existing mortgage loan volumes. Broadly speaking, the criteria for determining eligible SME loans should also be construed such that they would not restrict any bank from gaining access to this funding tool.

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.

Being construed as a dual recourse instrument, an investor would rely first on the intrinsic soundness of the issuer, then on the 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 important features such as asset segregation, public supervision and other structural elements will contribute to the overall soundness of the instrument.

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 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, when compared to similar maturities, should price tighter than a securitisation (limited recourse instrument) but at the same time wider than the traditional dual recourse covered bond. Overall, ESNs are expected to offer a pick-up versus

[10] Discussions are ongoing whether to include in the scope also larger enterprises. Overall granularity of the cover pool should however remain ensured, also to be consistent with rating agencies criteria (please see below).

traditional mortgage-covered bonds but should provide a funding advantage concerning 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. Investors with a higher risk appetite might seek higher yields. Finally, the perspective for a favourable regulatory treatment of ESNs and their potential role in sustainable recovery would also attract traditional covered bond investors.

In comparison to SME securitisation, ESN should be a more cost-efficient tool for the issuers and a 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 make sense if the issuer taps the markets with large amounts in order to optimise structuring costs. Not only large banks but also medium-sized, 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 a fraction of the initial set-up costs.

Buyers currently choose covered bonds mainly for (i) regulatory reasons (LCR etc), (ii) secondary market performance (given ECB purchasing), (iii) the necessity to meet index requirements and (iv) 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.

ESN as a Funding Tool for Sustainable Recovery

ESN as a collateralised funding tool would enhance transparency, also for ESG purposes on the relevant stock of SME underlying assets. The EU legislation for ESG disclosure is currently focusing on large companies and progressively on listed SMEs, taking into account that most of the existing stock of SME loans is not ESG compliant. Therefore, starting to collect information on small and micro-SMEs will be the real challenge for the coming years, considering their stake in the EU economy. In this context, we strongly advocate that the ESN can act as a medium-term vehicle for EU decarbonization through the gradual financing of ESG assets.

There are, however, positive signals both on methodologies and best practices on how also small SMEs can contribute to the data collection. Namely, based on the findings of the EU TranspArEEns project[11] carried out by Ca' Foscari University, it emerged that ESG data can be collected through a structured survey also from micro-SMEs. Furthermore, rating agencies envisaged a system of credit scoring at portfolio level which could be applied to SME portfolios. Though the ESN project started in 2015, well before the launch of the EU Green Deal, the ESG dimension needs to be considered in order for the ESN to become successful in the context of the EU transition and for its ability to provide sustainable credentials to the supply chain of SME loans.

How to address the non-ESG-compliant existing stock? This is an issue already faced in the green covered bond issuances: in the context of CB programmes, issuers use their existing stock of assets as collateral and commit to finance new ESG assets or projects with the proceeds of the issuances, and those assets will eventually be included in the cover pool during the replenishment phases. The ESG ESN could follow that path and therefore become a vehicle for the progressive transition of the SME sector in the EU.

To foster a progressive harmonised disclosure of SME ESG information we could certainly take stock of the positive experience of the Covered Bond Label Harmonised Transparency Template (HTT) which started to include ESG-related information since 2017, and which is currently presenting information on EUR 135 bn worth sustainable CB. The HTT has been positively considered by the ECB in its effort toward the availability of ESG data on the various types of collateral. A similar approach would also be followed for the ESN. The TF is already working since the onset with Rating Agencies to develop a truly unified reporting tool and data template useful for investors and supervisors. In this context, the information provided through a harmonised market-based template could also benefit and widen the scope of the ESAP (European Single Access Point) initiative.

[11] EU-funded project focusing on the standardisation of ESG data in SMEs, which analysed ESG data collected by around 3,000 SMEs between the EU and the UK. For further information: https://pric.unive.it/projects/transpareens/home

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.

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 exclusion from bail-in-, ii) the eligibility under ECB rules for use as repo collateral 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 bonds, 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 ESNs 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 on 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, where the implementation of the CBD has not deployed its full effect yet. Being a similar technique to building up funding programmes (asset segregation, public supervision, over-collateralisation and transparency requirements), a parallel introduction of the two financial instruments could facilitate the expansion of capital markets using different asset 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 in this respect.

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.

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 could also be compatible with synthetic risk transfer solutions, without changing the dual recourse basic structure of the product. A way in which ESNs could be made compatible with 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 a funding tool, this note will not focus on such a possibility, leaving it, if the case may be, to the specific portfolios and objectives of prospective ESN issuers.

3. ESN Cover Pool Eligibility Criteria

The ESN, to be useful and successful, must be conceived as a sound and anti-cyclical product, contributing to EU financial stability. The efforts of the ESN TF have been deployed toward this goal, starting from analysing the CB characteristics of a dual recourse mechanism and adapting it to the SME asset class[12]. The TF members worked on the asset features and eligibility in order to ensure overall quality. The works undertaken considered the heterogeneity of SME loans together with the wide difference in SME needs throughout the EU.

Definition of SME

There are currently different definitions of SMEs at the 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 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 of 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. In fact, the overwhelming majority (over 93%) 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 exposure to micro-businesses.

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

[12] 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, as well as it may depend on specific infrastructure needs of the different countries. However, infrastructure finance (as observed in project finance) widely differ. In order to introduce infrastructure ESNs more work would need to be done to distinguish more clearly the latter from public sector covered bonds and to evaluate the business potential versus one another.

companies 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.

For the sake of portfolio stability, the SME eligibility criterion should be 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[13] cap of 2.5 Mio EUR (per the limit of the SME-Supporting-Factor in Art. 501 CRR) or as a proportion of the cover pool.

Further adaptations of the SME or enterprise criterion might be 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.

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 at this stage 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. The ESN Task Force stands ready to assist Competent Authorities in the analysis of specific SME exposures, if relevant.

Primary Cover Assets: Exposures to SMEs

- Unsecured exposures: In many cases, loans to SMEs will be granted without security based on 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 the 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.

  Concerning 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:
  - 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 such assets cannot be identified at first glance (see for example 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 the EU level. It is noted that in

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

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 EU Green Bond standards

Substitution Cover Assets

Substitution assets can be used in case there is a breach or risk of a 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 their maximum amount in the context of the programme.

Derivative Contracts

The TF recommends that derivative contracts should be allowed to be included in the cover pool for risk hedging purposes, more precisely for the hedging of interest rates and foreign exchange. The cover pool eligibility requirements should be the same as those defined for traditional covered bonds (please also refer to Section 3 on Micro-structural features).

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[14]. In consequence, sufficiently prudent eligibility criteria should be defined and a number of risk mitigation criteria should apply at the cover pool level.

Our suggestion is that the legislation of the ESN should ensure overall soundness at the macro-prudential level, obtained through a combination of asset eligibility and composition, legal and structural features and supervisory oversight.

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.

An SME cover pool has two fundamental differences vis-à-vis the CB cover pool containing mortgages: the lack of a real estate guarantee in the majority of cases and the heterogeneity of assets. In fact, differently from the mortgage market where the LTV indicator is commonly used as a first proxy to ascertain the risk taken by the lender considering the value of the real estate guarantee, there is a high level of heterogeneity of SME assets and no clearly shared proxy to assess the credit quality of SME loans. At first sight, a potential candidate for the ESN would be the probability of default (for IRB banks, or credit scoring for banks under a standardised approach), but its pro-cyclicality and high volatility would hamper the goal of the ESN of providing anti-cyclical financing instrument.

It must also be considered that the level of over-collateralisation (OC) contributes to the overall soundness of the product. Due to the nature of -mainly- non-guaranteed assets we expect the ESN to require a minimum legal level of OC higher compared to the one set in the CB framework. In assessing the right OC requirement for the relevant programme, the scoring of the SME assets is nevertheless taken into account in the criteria and analysis performed by the rating agencies.

Against this background and considering a combined approach, the pool needs to ensure the asset quality of the cover pool through multiple elements:

(i) homogeneous pools, which would avoid the presence of different types of exposures (e.g. mixing SME term loans with revolving facilities, or with lease assets). It has been suggested in the TF meetings that the homogeneity criteria set out in the context of the Securitisation Regulation could serve as a basis for the ESN;

(ii) granular loans, also establishing, on a programme basis, concentration limits (e.g. individual debtor, industry sector, geography, etc.);

[14] 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.

(iii) sound credit performance of the assets included in the cover pool (e.g. past delinquency).

The quality of the pool over time must be ascertained at the outset of the programme and furthermore must be ensured through its life with the performance of coverage tests at certain pre-established deadlines (in line with the best practice of covered bonds). The challenge will be to find the right balance between minimum legal certitude to ensure an overall asset quality and flexibility at each programme level, which in any case needs to meet rating agencies requirements.

Summing up, the overall performance of ESN bonds should not be only dependent upon the inherent credit risk of the collateral assets, on the contrary, it is expected to be also driven by its structural protection mechanisms, including OC and asset-liability matching, but also on other structural elements such as the specific combination of eligibility criteria applied to the cover pool (as detailed above) and the strength, origination and servicing capabilities of the issuer.

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. 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 the 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-collateralisation in combination with a sufficient level of granularity of SME loans is a further appropriate criterion for securing the cover pool against asset volatilities potentially triggered by shorter maturity profiles and compensating 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 and 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 must be removed from the cover pool or excluded from the calculation of the coverage requirement. In this context, regarding avoiding pro-cyclicality, further analysis is recommended once an ESN programme is launched.

4. Analysis of Structural Features

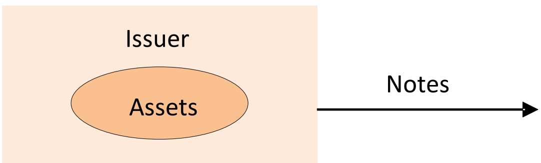
Macro-Structural Features - Potential Structures

This Section illustrates some of the structures that European Authorities and 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 macro-structure 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, 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 macro-structure used for covered bonds and implement one of the other proposed structures.

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 the 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 the 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 the balance sheet could not be possible at present due to constraints related to the relevant legal and regulatory frameworks.



Key Characteristics

- The 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 a 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.

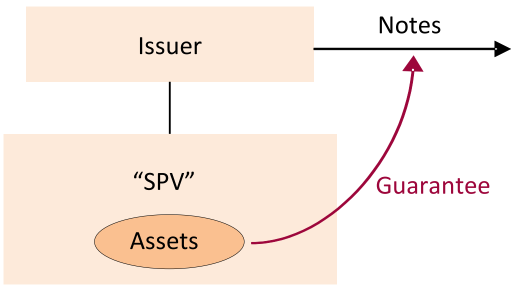
Implications

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 an 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.

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 ensures legal asset segregation and 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.



Key Characteristics

- Similar to covered bond structures in certain European countries (Italy, Netherlands, UK).
- The issuer remains the bank but the assets are transferred off-balance sheet to an SPV, Guarantor.
- Used when existing law allows the transfer of assets using securitisation technologies effectively.
- Furthermore, please note that this structure was used for the Commerzbank SME Covered Bond and is the structure currently contemplated for OBC in Italy in the primary law.

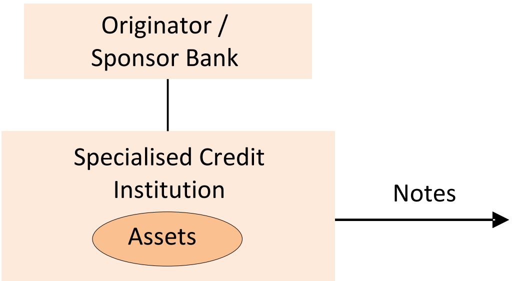
Implications

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 concerning the general insolvency estate of the issuer.
  - Most activities remain at the 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.
  - A separate entity will need to be established, so the process for the establishment of the ESN programme can be longer.
  - Regulatory limits on intra-company exposures typically need to be addressed by the existing law.

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 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 to cover assets which remain however on the sponsor bank's balance sheet.



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 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.

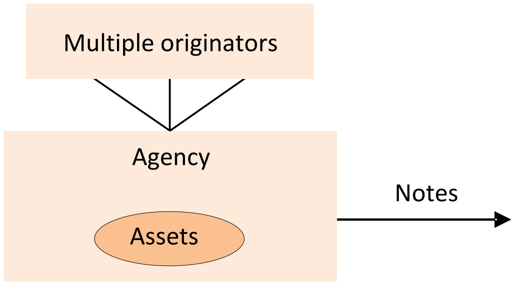
Joint Funding/Pooling Structure Model

This fourth structure has been introduced to allow credit institutions to pool their SME assets. It mimics the joint funding model that have been 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. smaller lenders) 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.



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, enable 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 several factors which may pose a challenge when choosing a 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 the maturity profile of the bonds), 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. the 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.

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Micro -Structural Features Analysis	
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?
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 on a common EU definition but rather favour a principle-based definition at the EU level and a requirement for 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 calibrating the liquidity buffer to the rating agencies' requirements currently ranging between 3-6 months 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 the 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 concerning 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 more than 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.

5. Next steps

The development of an ESN market depends both on market appetite as well as on a clear regulatory framework in which issuers, investors and stakeholders at large feel comfortable to operate. As outlined above, the introduction of ESN would bring bank funding diversification, additional support in SME financing, also through Central Bank eligibility and increasing transparency (including ESG aspects).

With this in mind, the ECBC will continue its work on gathering best practices and market insights and is ready to support the EU authorities in charge of assessing the necessary characteristics and potential legislation of the ESN in the spirit of open cooperation to ensure the success of this strategically important financial product for the financing of the EU SME sector.