1.6.1 Must-have Features for Successful ESN Issuances

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Last July the European Banking Authority (EBA) has been tasked by the European Commission with, inter alia, providing its views on European Secured Notes (ESN[1]), in particular whether the conclusions laid down in the Authority's report of 8 July 2018 on ESN remain relevant, or should otherwise be amended or followed up by additional advice. EBA's views will assist the Commission in preparing their report and potential legislative proposal on the ESN or followed up by additional advice, as provided in the Covered Bond Directive (CBD).

We therefore take this opportunity to contribute to the reflections of regulators and supervisors, taking into account the on-going assessment provided by the ESN Task Force of the ECBC, highlighting (i) the specific role the ESN instrument can play in the current economic environment, and (ii) describing two important features the instrument should embed. We will also make reference to some of the specific recommendations of the EBA 2018 report.

The context is the need for a competitive EU – especially regarding the SME sector – as monetary policy becomes less accommodating. Indeed, not only we have now higher interest rates, but also a phase out of the Eurosystem support for banks to SME financing (e.g. through TLTRO). In addition, through the roll-out of Basel implementation in the EU, a more stringent regulatory treatment is to be progressively established for unrated corporate financing. Therefore, we will see a combination of factors making SME lending, directly and indirectly, more expensive for banks, and hence for businesses.

The same EBA report in 2018 highlighted that, at the time of writing, banks were provided with "abundant and cheap funding". Clearly this is no longer the case.

A successful Capital Markets Union, as highlighted in the Letta Report recently presented to the European Council, remains paramount to channel financing and savings to EU companies. In this context, a wider toolbox for the specific financing of SMEs is of extreme importance. Accordingly, while banks could be incentivised to securitise exposures in order to transfer risk to investors, they could alternatively keep those same assets in their balance sheets, benefitting from lower refinancing costs through the use of ESN.

We will therefore elaborate on two specific aspects the ESN instrument should contemplate in order to be successful with investors: one is ensuring asset quality, the other is playing a critical part in the ESG transition of our economies.

1. How to ensure asset quality

The starting point is what kind of eligible assets are to be allowed in cover pools. Most SME assets are unsecured, unlike those supporting covered bonds, which are typically secured by real estate assets or public sector guarantees. Furthermore, within the ESN Task Force we have ascertained that SME asset types diverge from country to country, and this is linked to the types of local businesses, the financial sector where they operate, and their specific financial needs. Certain member states show a very diversified industrial exposure, whereas others are highly concentrated in a few sectors only.

This aspect was well recognised in the former EBA report on ESN, published in 2018, which highlighted this very important point and concluded that an overly prescriptive asset composition may hamper the development of the ESN instrument, and therefore legislators should be mindful that flexibility in the asset composition would be most effective option.

1 European Secured Notes are long term dual recourse instruments, issued by financial institutions, collateralized by SME exposures. Please refer to the ESN blueprint, published on the ECBC website.
[NOTE: the aim is to publish an updated version of the blueprint on ECBC website, in this case the current link would need to be updated] https://hypo.org/app/uploads/sites/3/2017/05/ECBC-ESN-Blueprint-April-2021.pdf

The question therefore is how to ensure the quality of the cover pool where assets are predominantly unsecured (and therefore the proxy of loan-to-value, one central criterium for covered bonds, does not exist)? The task force debated and tried to find a possible metric capable of capturing a first estimate of the asset quality of a single asset in the cover pool. Existing indicators, as the probability of default or the client's internal risk scoring, show high volatility, therefore instead of ensuring stability, promote pro-cyclicality.

The answer is given by standard rating agencies' criteria. It is not because an unsecured stand-alone asset has a higher LGD compared to, for instance, a real estate backed asset, that a liability with dual recourse on a portfolio of such assets is, per se, riskier than a covered bond. We know dual recourse instruments are based on the strength of the issuer, on the legal and structural elements, and on the cover pool characteristics. So, regardless of the specific sovereign risk, or the strength of the single issuer, let's navigate on how the portfolio selection could enhance the overall quality of the instrument.

Granularity of the portfolio

This is the first element to consider. How to ensure granularity? We suggest rules should be given, whereby concentration limits are clearly stated, at programme level, in order to avoid excessive concentration of exposures to (i) single obligor or economic groups, (ii) economic sector and implicit correlation among exposures, (iii) geography or region, and thus enhancing diversification as much as possible. Having concentration limits stated in documentation allows comparison between different programmes, making clear to investors the maximum concentration risk they are exposed to, also in order to price issuances of each programme accordingly.

Homogeneity of the cover pool

Considering the variety of SME asset classes, each ESN programme should avoid mixing up different products, for instance term loans and revolving facilities, leasing and factoring contracts. Ensuring homogeneity makes the due diligence on the portfolio by investors more straightforward. In addition, rating agencies would also be able to perform their analysis on the cover pool adopting one single methodology. All the work which has been performed so far on portfolio homogeneity in the context of STS securitisations could be easily replicated in the ESN context.

The rules described above should be kept along the life of the programme, meaning every new assignment of claims would follow exactly the same rules and investors would have the certainty that the cover pool keeps its general composition throughout time.

Such features may be easily ensured contractually with commitments clearly stated in the ESN programme documentation. Besides such commitments towards investors, regulation may also set some basic guidelines that issuers would need to follow. For instance, the EBA 2018 report makes some suggestions in terms of granularity (at least 500 exposures) and in terms of maximum concentration per borrower (not exceeding 2% of the total cover pool exposure value). Such high-level principles are in our opinion sensible, not overly prescriptive, and possible to be adapted to the specific programme's cover pool of each potential issuer.

Past performance of the assets

Not only each asset should be performing upon inclusion in the cover pool (as stated in the EBA report), but issuers may also set additional criteria concerning their past performance. Such additional criteria, to be applied in the portfolio selection by each originator, may reduce the overall eligible portfolio, but would yield additional comfort for investors. Data availability needs however to be born in mind when devising the extent and format of such past performance data.

Minimum Overcollateralization

The legally required coverage (i.e. minimum overcollateralization) will ensure additional protection upon a general deterioration of the cover pool and reduce liquidity risk. However, we do not share the reasoning of the EBA in the 2018 report which sets the minimum OC at a level exceptionally high, not considering the dual recourse of the ESN instrument, and which would risk to seriously discourage issuers.

2. ESN as a tool to facilitate the ESG transition

It is widely acknowledged that the availability of SME ESG data needs to be improved. All legislative provisions of EU regulators (e.g., CSRD) concern corporates and (larger) listed SMEs only. Yet SMEs, the vast majority of EU enterprises, while still having an important contribution to industrial pollution and waste, are also already investing significantly in sustainable projects, on which there is little or no data being collected, be it for lack of awareness or lack of incentive. Therefore, a gradual collection of ESG data through the inclusion of exposures in the ESN cover pools – and subsequently through the specific disclosure requirements – would constitute a valuable support to the overall EU ESG ambitious targets. We believe this support would come taking a two-fold approach. In other words, **ESN could become a driver for SME ESG data disclosure**, adapted to SME data collection capability.

Otherwise, and as is stands, data collection for the time being remains voluntary for SMEs, which cannot bear the costs and complexity of the compliance with EU Taxonomy, and other legislation applicable to larger corporates. However, there are positive signals showing that SME, even micro enterprises, if adequately trained and supported, are able to collect ESG data. One example is the TranspArEEns[2] project, promoted by the EMF together with Ca' Foscari University and other partners, financed by the European Commission. Therein a sample of more than 2,800 micro enterprises responded to a detailed survey, and were able to collect and disclose ESG data on their specific activities.

Furthermore, a report from the Platform on Sustainable Finance (PSF)[3] on more than 1,200 SME found out that most green finance activities are self-financed, hinting banks still have a role to play supporting their clients on this respect. In this context banks may help small SMEs in reporting their ESG data, in a voluntary and proportionate fashion, while generating assets eligible for ESN cover pools, minimizing the cost of funding such assets through a double-recourse instrument like an ESN, generating scope for more attractive credit terms to fund such activities, in a **virtuous circle around the financing of EU ESG transition**.

Based on the multi-annual use of the Harmonised Transparency Template (HTT), where a specific section of ESG data has been introduced and currently represents more than 145 bn green covered bonds, a specific template could be developed for SME loans for ESN programmes disclosure, that would meet investors' and supervisors' needs of ESG data on the SME sector.

What strategy can be used to ensure the transition? The EU Green Bond Standard may be of help in order to make use of the existing stocks of SME loans as initial collateral, whereby issuers commit to use the proceeds of their ESN issuances to finance new ESG loans, which will be eventually included in the ESN cover pool. Taking into account that SME assets have shorter maturities, the cover pool would then be replenished with newly advanced sustainable loans.

2 https://pric.unive.it/projects/transpareens/home#c12046

3 A compendium of Market Practices. How the EU's Taxonomy and sustainable finance framework are helping financial and non-financial actors transition to net zero, January 2024. Link: https://finance.ec.europa.eu/document/download/ff44591e-9d83-4027-a079-f3fe23bbaf41_en?240129-sf-platform-report-market-practices-compendium-report_en.pdf.
The Platform on Sustainable Finance is an advisory body established under the Taxonomy Regulation and subject to the European Commission's horizontal rules for expert groups.

Results from the PSF SME survey suggest that a significant part (58%) of surveyed SME have invested in sustainable projects and the EC (Annual Report on European SMEs 2022/2023), quoted in the same PSF report, confirms such tendency. This overall trend would enable banks to extend new ESG loans, thus **progressively greening the overall cover pool**.

ECBC is honoured to contribute, in the course of the following months, to the reflections of EBA and of competent Authorities in this field, in order to give the European Commission all required analysis coming from the market and from each of the EU jurisdictions represented by our association.