EBA recommendations on the Call for Advice on European Secured Notes

26 June 2018

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1. Mandate

- EBA received a Call for Advice (CfA) from the European Commission on European Secured Notes (ESNs) to be delivered by 30 June 2018.
- In the CfA, ESNs are defined as "**dual recourse financial instruments on an issuer's balance sheet applying the basic structural characteristics of covered bonds** to two non-traditional cover pool assets – SME bank loans and infrastructure bank loans".
- Requested assessments:
  - **The appropriateness of the EBA 2016 covered bond best practices for ESNs**.
  - **The appropriate risk treatment for ESNs** in light of their feature and expected risk profile and taking into account supervisory perspective and exiting regulatory frameworks.
  - **The impact of the instrument on individual banks' asset encumbrance and on unsecured bank creditors.**
  - **Any technical aspects that are of relevance to ESNs.**

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2. Business case (1/2)

Qualitative assessment

Pros	Cons
For SMEs loans: ▪ ESNs to overcome the lack of standardisation of SME investments ▪ ESNs to be complementary to ABS SMEs ▪ ESNs to possibly generate new investors with lower risk appetite thanks to the dual recourse mechanism ▪ ESNs to alleviate the pro-cyclical pattern of SME lending For infrastructure projects: ▪ New opportunity of funding in a context where infrastructure loans are unlikely to qualify as STS securitisations ▪ Wider investor base thanks to the standardisation ▪ Might be useful from an asset and liability management perspective	▪ Under current good funding condition a new funding tool is not needed ▪ Priority should rather be given to: ✓ Making the new STS framework attractive for the securitisation of SME loans ✓ Improving underlying data for SME loans across Europe ✓ Addressing the shortage of risk capital and equity finance to SMEs. ▪ For infrastructure loans: ✓ securitisation and capital debt relief instrument might work better ✓ the market is currently sufficiently funded *via* private infrastructure debt and specialised long term lenders. ▪ Risk of market confusion (if not clearly separated from traditional covered bonds)

2. Business case (2/2)

Assessment of the potential size of the ESNs

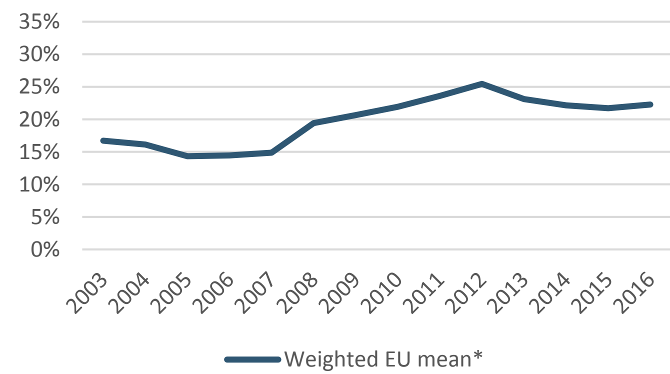
- Based on EBA 2017 transparency exercise, the **aggregate pool of SME and infrastructure exposures potentially available to be re-financed through ESNs is estimated at c.€ 4 trillion.**

- However not all SME and infrastructure exposures will be used to issue ESNs; several factors may limit the potential size of the ESN market including : structural diversification of bank funding, overlap with covered bond market, eligibility criteria for ESNs, MREL build up, *etc.*

- Assuming a coverage of SME and infrastructure loans comparable to the range observed for mortgage loans, **the size of the ESNs market could in between EUR 400 billion and EUR 1.2 trillion** (depending of the over-collateralisation assumptions).

- However, in the case where ESN is not fully subject to the same framework and regulatory treatment as covered bonds, **these figures will significantly overestimate the potential size of the market**

Mortgage backed covered bonds as percentage of residential mortgage loans



Source: EMD- ECBC 2017 Fact book

Estimates of the size of the ESN market in the near term (billion euro)

	Share of SME and infrastructure loans used to issue ESNs			
	100 %	10%	20%	30%
SME loans	3100	310	620	930
Infrastructure loans	800	80	170	250
Total ESNs market	3900	390	790	1180

Source: EBA calculation

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3. Impact on asset encumbrance (1/2)

Qualitative and quantitative assessments

Potential impact of ESNs on asset encumbrance

	Assuming same collateralisation level as for CB:118%			Assuming a collateralisation level of 130%			Assuming same collateralisation level as for ABS:138%		
Share of SMEs and infrastructures portfolios used for ESNs	**Volume of new encumbered assets(M EUR)**	**% of encumbrance**	**Impact on the ratio in pp.**	**Volume of new encumbered assets (M EUR)**	**% of encumbrance**	**Impact on the ratio in pp.**	**Volume of new encumbered assets (M EUR)**	**% of encumbrance**	**Impact on the ratio in pp.**
30%	1,394,760	30.1%	3.5	1,536,600	30.5%	3.9	1,631,160	30.7%	4.1
20%	929,840	28.9%	2.3	1,024,400	29.2%	2.6	1,087,440	29.3%	2.7
10%	464,920	27.8%	1.2	512,200	27.9%	1.3	543,720	28.0%	1.4

Source: EBA calculation

- Asset encumbrance would rise in the EU following the introduction of ESNs due to the dual recourse feature and the over-collateralisation requirement.

- The impact of higher levels of asset encumbrance on individual banks is not univocal. The introduction of a new and well-functioning secured funding instrument for SME and infrastructure exposures could improve overall, rather than to worsen, the risk profile of issuers particularly if the ESN market is of high liquidity and of sufficient resilience in times of financial stress.

- The potential increase in asset encumbrance levels has been estimated on the basis of hypothesis regarding the amount of available SME and infrastructure loans collaterals and the over-collateralisation level => As the whole the impact is assessed to be moderate : **+1.2 pp to +4.1 pp on EU asset encumbrance ratio as at December 2016.**

3. Impact on asset encumbrance (2/2)

Recommendation: Asset encumbrance

- The introduction of SME ESNs will not give rise to asset encumbrance implications for the EU banking system as a whole that cause concern in the current financial environment.
- However, over-reliance on secured funding and increasing levels of asset encumbrance may pose additional risks at national level or to individual institutions.
- Asset encumbrance has to be considered in the broad context of a bank's overall funding, liquidity and business model profile and not only at product level.
- Should ESNs become highly successful, potential asset encumbrance limits at an aggregate level (and not instrument level), at national level or for specific institutions could be considered.

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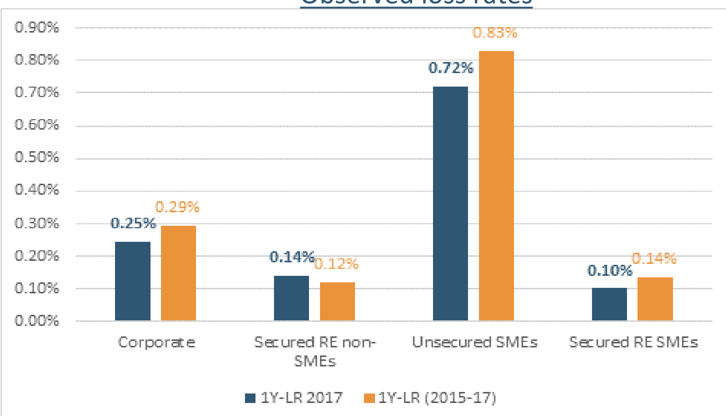
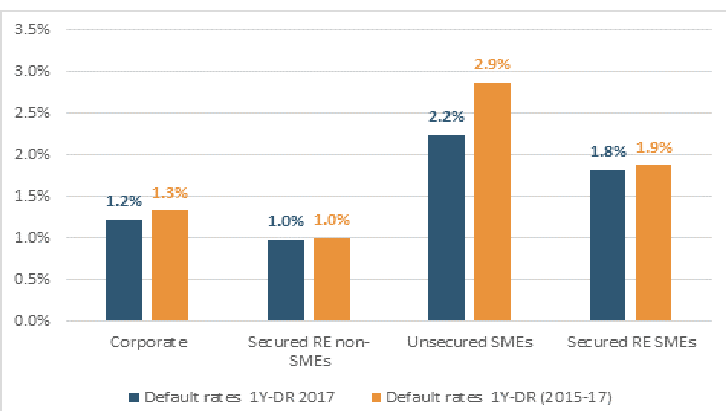
4. SME ESNs (1/5)

Performance of SME loans

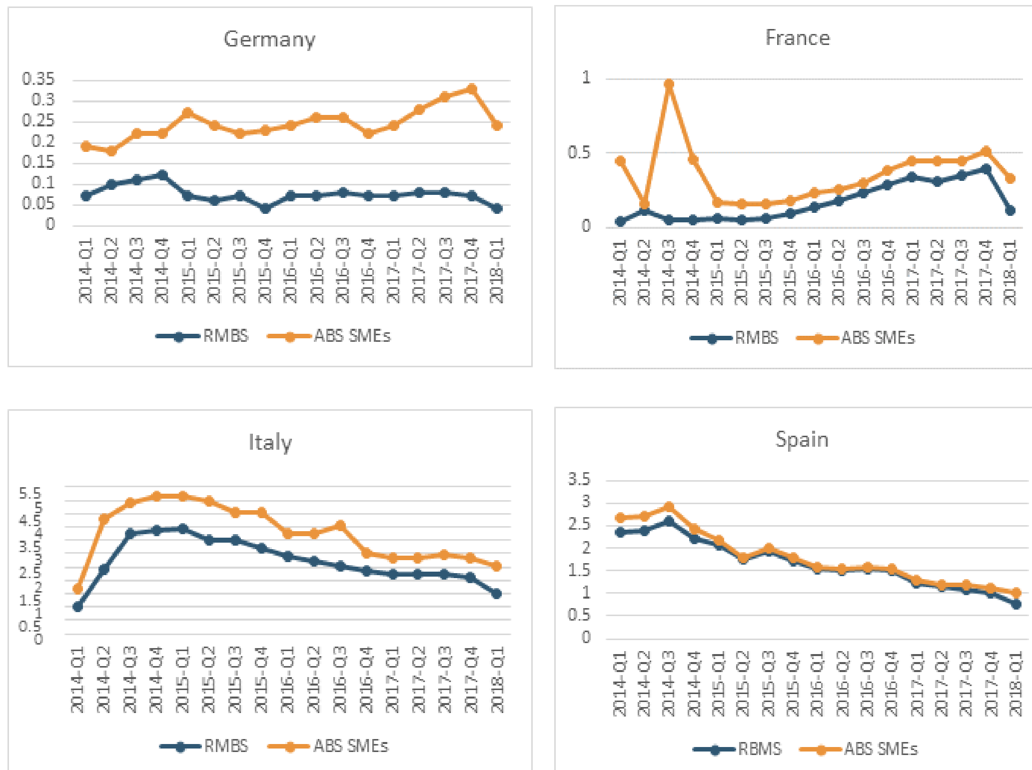
Observed loss rates



Observed default rates



Evolution of defaulted loans (% current balance)



Source: European Dataware House

Source: COREP

4. SME ESNs (2/5)

Recommendation: Structure and cover assets

- SME ESNs could be structured as dual recourse instruments, however, in contrast to covered bonds backed by real estate, the cover assets of SME ESNs would probably not be secured by a real estate underlying security.
- All of the 2016 EBA best practices on covered bonds could be appropriate in the context of SME ESNs. However, some adjustments to these best practices would be needed to account for the specific aspects of SME exposures. In particular, a more restrictive framework should be applied for several best practices including :
  i. composition of cover pools and cover pools with underlying assets located in different jurisdictions (Best practices 3A and B);
  ii. coverage principles and legal/regulatory over-collateralization (Best practice 5);
  iii. liquidity buffer (Best practice 6) and,
  iv. scope of disclosure (Best practice 8A).

4. SME ESNs (3/5)

Recommendation: Structure and cover assets (continuation)

- Because of the high credit risk and refinancing risk that characterise SME exposures, the EBA recommends incorporating strict cover assets eligibility criteria at both loan and pool levels.
  - Asset scope: only SME loans and leasing exposures to SMEs (as defined in the CRR) should be included in the cover pool. Other types of SME exposures such as overdraft and factoring should be excluded because of their typically short maturity.
  - Quality standards: SME loans have to be non-defaulted and credit institutions engaged in SME ESNs should have sound and well-defined credit underwriting standards.
  - Granularity of the cover pool: the granularity of the cover pool should be sufficiently high, i.e. the pool should contain at least 500 exposures.
  - Concentration of the cover pool: The cover pool should not be subject to material concentration, i.e. the aggregate exposures value to a single obligor in the cover pool should not exceed 2%.
  - Mandatory minimum OC requirement:
    - ✓ A minimum level of O/C of **at least 30%** should be met at all times.
    - ✓ For the purpose of calculating the requirement, defaulted SME exposures should not be taken into account and the provisions should be deducted from the nominal amount of the cover assets.

4. SME ESNs (4/5)

Recommendation: Regulatory treatment

- **Credit risk treatment under CRR :**

  - Based exclusively on the performance of the underlying assets, no preferential risk weight treatment could be justified for SME ESNs.

  - However, taking into account the structural and cover assets enhancements proposed in Recommendation 1, a differentiated risk weight requirement compared with unsecured exposures to institutions could be considered.

  - When calibrating the appropriate risk weight framework applicable to SME ESNs, the following elements, at least, should be taken into account :
    - The dual-recourse feature of the instrument, structural enhancements and cover assets eligibility criteria will improve the risk profile and credit quality of the instrument.
    - The overall consistency of the CRR capital framework between exposures classes is respected. Especially, the capital treatment of SME ESNs :
      1. should be based on the actual risk profile of the underlying exposures,
      2. should not create unjustified level playing field issues at the expense of non-preferred covered bonds . A holistic review of the existing framework for comparable instruments should also be considered.
    - A clear distinction between the prudential framework of SME ESNs and covered bonds is maintained to avoid market confusion and potential negative reputational side effects on the covered bond market.

4. SME ESNs (5/5)

Recommendation: Regulatory treatment (continuation)

- **Treatment under the LCR:** The prudential treatment of SME ESNs under the LCR cannot be reasonably determined because the liquidity of this instrument cannot be measured, since the instrument does not currently exist, and its liquidity cannot be prudently estimated. Therefore, it is suggested that SME ESNs should not be subject to a preferential liquidity treatment until such an assessment is performed.

- **Treatment under UCITS (retail investment and investment threshold) :** Provided that SME ESNs are issued by credit institutions, are subject to many of the fundamental features identified as best practice for covered bonds and meet all the additional relevant UCITS criteria, a preferential investment threshold under UCITS could be considered. The Commission should also consider consulting other relevant ESAs to further assess the feasibility of SME ESNs benefiting from preferential treatment under UCITS.

- **Treatment under EMIR (exemption from collateral posting) :** Provided that SME ESNs are issued by credit institutions, and are subject to many of the fundamental features identified as a best practice for covered bonds and to the specific arrangements under which ESNs can mitigate counterparty risks, an exemption from posting collateral under EMIR could be considered. The Commission should also consider consulting other relevant ESAs to further assess the feasibility of SME ESNs benefiting from preferential treatment under EMIR.

- **Treatment under the BRRD:** The regulatory treatment of SME ESNs in the context of the BRRD should be comparable to that of secured liabilities. Therefore, SME ESNs could be exempt from bail-in.

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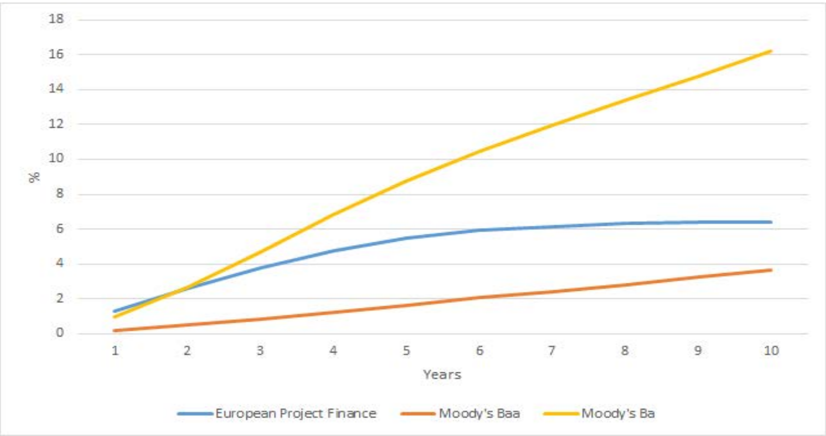
5. Infrastructure ESNs (1/4)

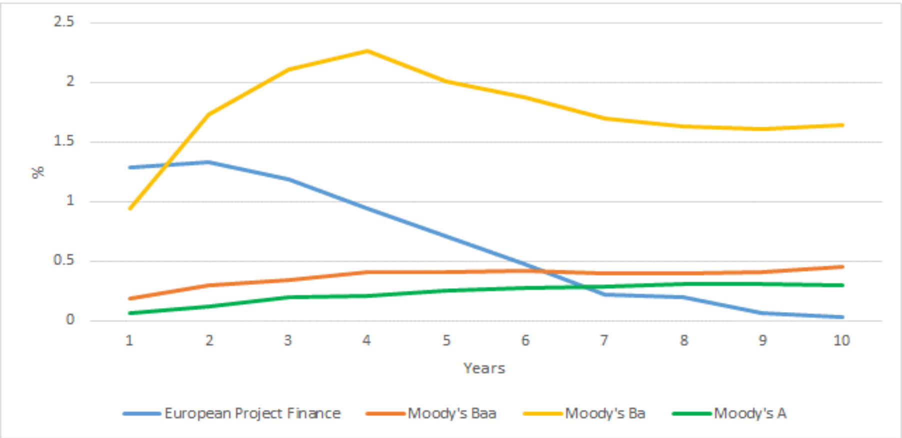
Performance of infrastructure projects

Cumulative default rate of European Project Finance



Source: Data Alliance Project Finance Data Consortium

Marginal annual default rates of European Project Finance



Source: Data Alliance Project Finance Data Consortium

Distribution of defaults and ultimate recoveries by project phase

	Defaults	Average year to default	Recovery rates
Construction	28	2.70	66%
Operational	161	4.94	76%
Total	189	4.6	74%

Source: EBA calculation, Data Alliance Project Finance Data Consortium

5. Infrastructure ESNs (2/4)

Recommendation: Structure and cover assets

- A dual recourse structure would not be appropriate in the case of infrastructure exposures. Accordingly, most of the 2016 EBA best practices on covered bonds would not be relevant given the bespoke nature, the complex structure and the lack of granularity characterising infrastructure loans.
- In particular :
  - Compared with the real estate exposure class, the infrastructure projects asset class is more heterogeneous and cover a wide range of very diverse assets.
  - The average amount of exposure to infrastructure projects is usually significantly higher than the exposure amount of a typical exposure underlying covered bonds.
    - making it difficult to create an infrastructure ESN instrument with a similar risk and underlying credit risk profile.
- In addition, the dual recourse feature of the infrastructure ESN might be less suitable for institutions, given the relatively high regulatory capital consumption of infrastructure exposures.

5. Infrastructure ESNs (3/4)

Recommendation: Structure and cover assets (continuation)

- The data analysis shows a clear difference in the credit risk between project finance loans during the construction phase and loans in the operational phase, with the latter showing substantially lower credit risk.
- The EBA also notes that in prudential regulation (Basel, Solvency II and CRR 2 proposal) a differentiation is made between different project finance loans based on certain criteria.
- Should the Commission intend to further assess the case for a funding instrument for infrastructure exposures, the EBA would recommend restricting the cover assets to project finance loans in the operational phase and the eligibility criteria proposed in the CRR 2 proposal relating to project finance exposures, in particular points (a) to (c) of Article 501a.

5. Infrastructure ESNs (4/4)

Recommendation: Regulatory treatment

- As the EBA advises against the dual-recourse feature for infrastructure ESNs, no assessment of its potential regulatory treatment has been carried out.
- Although the EBA does not consider a dual-recourse ESN appropriate for project finance loans, the EBA is of the view that a new distinct class of off-balance-sheet funding instruments for high-quality project finance loans could be considered in the form of an EU infrastructure bond. In particular, a standardised infrastructure bond secured by infrastructure loans transferred and segregated into an SPE, and offering the credit institution some degree of capital relief through risk transfer, might be more suitable.
- This new product could be standardised into a pan-European framework and could be subject to special public supervision. However, further work would be needed to further specify the features of this potential new funding instrument, its assignment under the CRR exposure classes and its regulatory treatment.
- Against this background, the European Commission might consider issuing a call for advice to the EBA to investigate the case for a standardised EU infrastructure bond.

Thank you for your attention!

Questions?