

EUROPEAN COMMISSION

Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Director General

Brussels, **03 OCT. 2017**
fisma.c.1/SS/er (2017) 5361886

Mr. Andrea Enria
Chairperson
European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA
United Kingdom

Subject: Call for advice to the EBA on European Secured Notes

Dear Mr. Enria,

The Communication on the Mid-term Review of the Capital Markets Union (CMU) Action Plan of June 2017¹ announced that the European Commission plans to adopt a legislative proposal for an EU framework on covered bonds and assess the case for European Secured Notes (ESNs) for SME bank loans and infrastructure bank loans. The ESN asset class aims to cover a funding segment located between traditional covered bonds and STS securitisations. It could increase the variety of funding tools available to banks unlocking more financing for SMEs and infrastructure projects, and contributing to economic growth and investment.

The European Banking Authority (EBA) has already performed extensive work on covered bonds², identifying best practices and issuing recommendations on harmonisation of covered bond frameworks in the European Union (EU). Building on this work, the Commission Services would like to invite the EBA to assess the following three aspects:

- (i) The extent to which these best practices for covered bonds could be applicable on a *mutatis mutandis* basis to ESNs
- (ii) The appropriate risk treatment of ESNs in light of their features and expected risk-return profile
- (iii) The effects ESNs could have on individual banks in terms of asset encumbrance impact on unsecured bank creditors.

Please find enclosed the Call for advice for more information on its scope and objectives.

We intend to complete the assessment of the case for ESNs as announced by Q2 2018, and we would therefore like to receive EBA's final report **by 30 April 2018**.

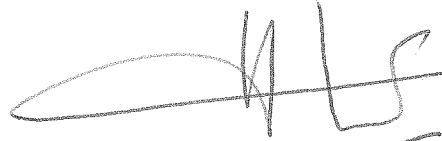
¹ Communication on the Mid-term Review of the Capital Markets Union (CMU) Action Plan, COM(2017) 292 final, 08.06.2017

² EBA report on EU covered bond frameworks and capital treatment, 1 July 2014; Opinion of the European Banking Authority on the preferential capital treatment of covered bonds, 1 July 2014; EBA Report on covered bonds – Recommendations on harmonisation of covered bond frameworks in the EU, 20 December 2016

Unit C1 'Capital Markets Union' stands ready to provide the EBA with any clarification and support needed to complete this assessment. Should you have any questions, please contact Mr Stefan Sapundzhiev (telephone: +32 2 29 63266).

Thank you in advance for your cooperation. I look forward to receiving the EBA's advice.

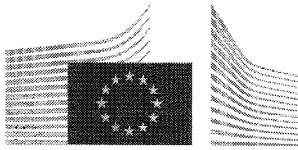
Yours sincerely,

A handwritten signature in black ink, consisting of a large, sweeping loop on the left and a more complex, stylized structure on the right that includes the letters 'G' and 'S'.

Olivier GUERSENT

Cc.: L. Overby, C. Moor, J. Kovalcikova, M. Rimarchi (EBA); N. Bohan, J. Lichtenberger, D. Millerot, M. Levin, V. Miceli, C. Host-Madsen, L. Andreeva-Paskov (DG FISMA)

Enc.: Call for advice to the EBA on European Secured Notes



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Call for advice to the EBA on European Secured Notes

Context

The Communication on the Mid-term Review of the Capital Markets Union (CMU) Action Plan of June 2017³ announced that the European Commission plans to adopt a legislative proposal for an EU framework on covered bonds and assess the case for European Secured Notes (ESNs) for SME bank loans and infrastructure bank loans. The aim is to strengthen banking capacity to support the wider economy through more market funding. This strengthening could increase the variety of financing sources available to SMEs and improve long-term, infrastructure and sustainable investment.

For the purposes of assessing the case for ESNs, the Commission Services define an ESN as a dual-recourse financial instrument 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. ESNs could be issued as a classic direct on-balance sheet covered bond without transferring the assets to an external entity or as an on-balance sheet covered bond with a separate guarantor to whom the cover pool assets are transferred.

The European Banking Authority (EBA) has already performed extensive work on covered bonds⁴, identifying best practices and issuing recommendations on harmonisation of covered bond frameworks in the EU. It has also provided advice on the SME supporting factor⁵.

Scope and objectives of the advice

Building on this work, the Commission Services would like to invite the EBA to:

1. Assess the extent to which the best practices identified in its December 2016 report on covered bonds could be used as a basis for ESNs backed by SME bank loans and infrastructure bank loans (see Annex 1 for the list of these best practices). All best practices are to be assessed except for best practice 4-A (LTV limits) and best practice 4-B (LTV measurement and frequency of revaluation).

It is very important to underline that the two asset classes expected to secure ESNs – SME bank loans and infrastructure bank loans – are fundamentally different and need to be assessed separately. They exhibit different risk profiles, purposes, sizes, maturities, levels of granularity and concentration, credit ratings, and interest and default rates. In addition, the sources of

³ Communication on the Mid-term Review of the Capital Markets Union (CMU) Action Plan, COM(2017) 292 final, 08.06.2017

⁴ EBA report on EU covered bond frameworks and capital treatment, 1 July 2014; Opinion of the European Banking Authority on the preferential capital treatment of covered bonds, 1 July 2014; EBA Report on covered bonds – Recommendations on harmonisation of covered bond frameworks in the EU, 20 December 2016

⁵ EBA Report on SMEs and SME Supporting Factor, 23 March 2016

income used to service the two kinds of loans differ substantially. Therefore, each best practice on covered bonds should be analysed separately for its applicability to ESNs backed by SME bank loans and to ESNs backed by infrastructure bank loans.

For the purposes of this Call for advice, infrastructure bank loans are defined as credit exposures to entities that operate or finance physical structures or facilities, systems and networks that provide or support essential public services. This definition is in line with the one for infrastructure assets in the Commission's Solvency II Delegated Regulation⁶ and the proposed Article 501a in the Regulation amending the Capital Requirements Regulation (CRR)⁷.

2. Assess, from a supervisory perspective, what the appropriate risk treatment of ESNs could be in light of their features and expected risk-return profile. For this assessment the EBA should consider different scenarios for regulatory and prudential purposes, taking into account the EU legislative acts in Annex 2, as well as existing frameworks, programmes and structured products collateralised by SME bank loans and/or infrastructure bank loans.
3. Assess what effects ESNs could have on individual banks in terms of asset encumbrance impact on unsecured bank creditors. For this assessment the EBA should take into account its reports on asset encumbrance, as well as the dynamic nature of the cover pool, the potential decrease of bail-inable debt in case of an issuer's resolution and the potential reduction of recovery value in case of a fire sale upon an issuer's insolvency.
4. Highlight any technical aspects that are of relevance to ESNs.

Final considerations

In order to complete the ESN feasibility assessment within the deadline given in the CMU Mid-term Review Communication (Q2 2018), the Commission would need to receive the EBA's final report by 30 April 2018.

⁶ Commission Delegated Regulation (EU) 2016/467 of 30 September 2015 amending Commission Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for several categories of assets held by insurance and reinsurance undertakings

⁷ Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012, COM(2016) 850 final, 2016/0360 (COD)

Annex 1 - Best practices on covered bonds to be assessed for applicability to ESNs backed by SME bank loans and ESNs backed by infrastructure bank loans

All best practices for covered bonds identified by the EBA in its December 2016 report and listed below are to be assessed separately for applicability to ESNs backed by SME bank loans and ESNs backed by infrastructure bank loans, except for best practice 4-A (LTV limits) and best practice 4-B (LTV measurement and frequency of revaluation).

- Best practice 1: Dual recourse
- Best practice 2 – A: Segregation of the cover assets
- Best practice 2 – B: Bankruptcy remoteness of the covered bond
- Best practice 2 – C: Administration of the covered bond programme post the issuer's insolvency or resolution
- Best practice 3 – A: Composition of cover pools
- Best practice 3 – B: Cover pools with underlying assets located in different jurisdictions
- Best practice 5: Coverage principles and legal/regulatory overcollateralisation
- Best practice 6 – A: Use of derivatives
- Best practice 6 – B: Liquidity buffer
- Best practice 6 – C: Stress testing
- Best practice 7 – A: Appointment of the cover pool monitor
- Best practice 7 – B: Supervision of the covered bond issuer
- Best practice 7 – C: Duties and powers of the national authority in a scenario of the issuer's insolvency
- Best practice 8 – A: Scope of disclosure
- Best practice 8 – B: Frequency of disclosure

Annex 2 - EU regulatory and prudential framework on covered bonds

- Directive 2009/65/EC on Undertakings for Collective Investment in Transferable Securities – Article 52(4)
- Capital Requirements Regulation (EU) No 575/2013 – Article 129
- Commission's Delegated Regulation (EU) 2015/35 ("Solvency II Delegated Act") – Articles 180(1) and 187(1)
- Commission's Delegated Regulation (EU) 2015/61 with regard to Liquidity Coverage Requirement for Credit Institutions
- Bank Recovery and Resolution Directive – Article 44(2)
- Regulatory and Implementing Technical Standards (RTS) under the European Market Infrastructure Regulation for risk mitigation of non-cleared derivatives.