30 July 2018

Commentary

The tentative case for European Secured Notes: outcome uncertain

The European Banking Authority is advocating caution in setting parameters for European Secured Notes. Whether there is a real need for ESNs and whether they make it over the finish line to form a viable new asset class is far from assured.

Policymakers continue to push ahead to carve out the individual building blocks of CMU. Securing a constant flow of SME bank lending and eradicating pro-cyclicality are challenges. Could ESNs, a covered bond-like dual-recourse instrument, be the answer?

On the basis of the EBA's July 24 final report to the European Commission, the answer is tentative. In a stressed funding scenario, it says SME ESNs *might* provide a useful additional source of funding, especially for small institutions that do not have access to the securitisation market and/or have difficulty issuing unsecured long-term debt (Scope Italics). Hardly a ringing endorsement.

Market participants point to second-tier Spanish and Italian banks or those with less than stellar credit ratings as potential beneficiaries of the product. With more constricted market access windows, funding alternatives like ESNs might be of value for banks with hefty TLTRO refinancing requirements and large SME portfolios.

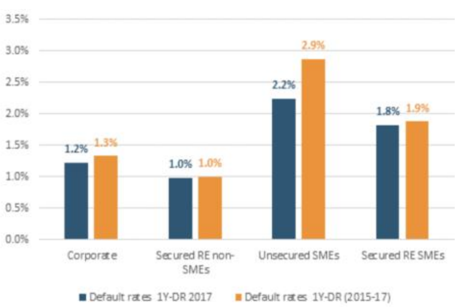
Based on the proportional take-up of European mortgages in mortgage covered bonds, the EBA logged the notional high-low boundaries of SME ESN issuance at EUR 310bn-EUR 930bn – 10%-30% of the EUR 3.1trn stock of SME exposures available to be re-financed. Whether ESNs take off will depend on the ability of structurers to make the product economically viable for issuers (itself partially dependent on regulatory treatment) at the same time as it meets investor needs.

The plan on paper is for ESNs eventually to form one leg of a continuum of discrete but conceptually similar products that will enable bank originators to re-distribute or re-assign claims to or refinance assets to get to the Commission's ultimate goal of assuring a constant flow of bank lending into the economy.

The EBA concluded that infrastructure loans are not appropriate to act as dual-recourse ESN underlyings; a reasonable assessment. But its call for securitised EU infrastructure bonds – yet another discrete structured product designed specifically for high-quality project finance loans – is a less-than-optimal solution.

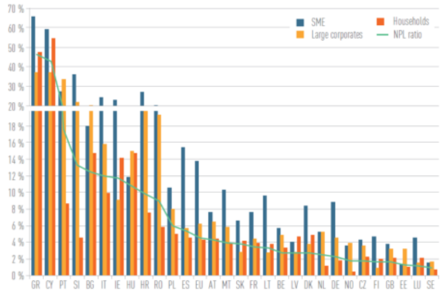
There are challenges, even for SME ESNs. In the context of defining the parameters for the product, the fact that SME loans suffer significantly higher default rates than mortgage loans (5x-7x), are heterogenous, typically unsecured and lack LTV tests to help lenders calibrate degrees of risk poses issues.

Chart 1: Observed default rates



Source: EBA

Chart 2: NPL ratio by sector, Q2 2017



Source: EBA risk indicators

Author

Keith Mullin
k.mullin@scopegroup.com

Analysts

Guillaume Jolivet
Head of Structured Finance
g.jolivet@scoperatings.com

Karlo Fuchs
Head of Covered Bonds
k.fuchs@scoperatings.com

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Productisation

Preferential risk-weight conditionality

Whether there is a real need for SME ESNs and whether they can be successfully productised remains to be seen. At the heart of the discussion is how to box SME loans into a more standard risk profile within a prudential framework that complements parallel work streams while offering the asset class a degree of differentiated regulatory treatment in order to drive issuer and investor interest.

SME ESNs won't receive preferential capital treatment based solely on the performance of the underlying assets, but the EBA said compared with unsecured exposures to institutions, a differentiated risk-weight requirement could be considered, provided certain conditions are met:

They will need to have a dual-recourse feature (including structural and cover-asset eligibility criteria that provide sufficient additional credit enhancement and mitigate many of the risks of the underlying assets)

The overall consistency of the CRR capital framework between exposure classes will need to be respected. Capital treatment should be based on the actual risk profile of the instrument and should not create unjustified level playing field issues at the expense of non-preferred covered bonds.

And perhaps closest to the hearts of policymakers and market participants, there will have to be a clear distinction between the prudential frameworks for SME ESNs and covered bonds to avoid market confusion and potential negative side-effects on the covered bond market.

See summary of eligibility criteria on p4.

Widening scope for SME ABS

Rather than trying to find a third way and create a new funding tool that fits into the gap created by the boundaries of parallel work on securitisation and covered bonds, it is reasonable to ask whether the perceived problem of securing that constant flow of SME financing can be better solved by deepening work on other work streams.

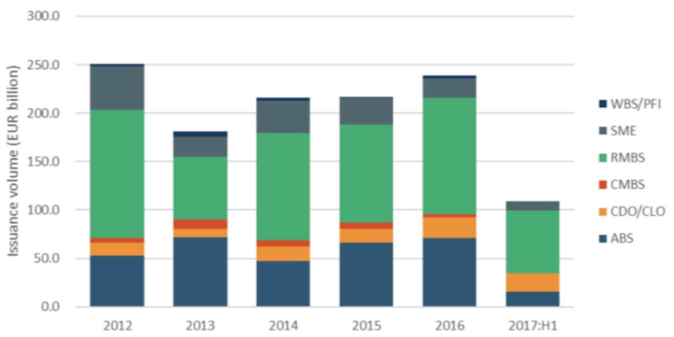
Improving basis for SME securitisation

The covered bond door is firmly shut, but there is room to deepen SME ABS markets. The Securitisation Regulation (EU) 2017/2402 and related Securitisation Prudential Regulation (EU) 2017/2401 have already unified rules governing euro area ABS/MBS, including a framework for Simple, Transparent and Standardised (STS) securitisation, and updated relevant aspects of the CRR.

Creating SME ESNs as a twin to a functioning SME ABS market looks unnecessarily over-engineered and even redundant; the intrinsic need for a lookalike product unproven. The EBA very reasonably asked itself whether too much time and effort were being expended on a blueprint for a new product when more time could be spent on making the STS framework more attractive for SME securitisation.

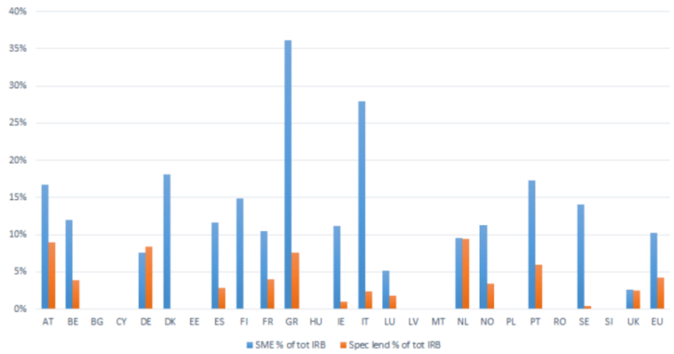
Improving the basis for SME securitisation under the umbrella of the STS framework might be a better way forward insofar as it creates a single SME tool that can be used for funding and regulatory capital relief.

Chart 3: European Securitisation by Collateral



Source: EBA

Chart 4: SME exposures and specialised lending (% of total IRB portfolio)



Source: EBA transparency exercise (data as of June 2017)

Pricing niche

Can ESNs fit into the emerging pricing paradigm?

Covered bonds, senior preferred and non-preferred debt, and ABS are already jockeying for position from a pricing perspective among issuing banks. ESNs will need to find their niche. But until the ECB ends its buyer-of-first-resort status and the credit market finds new-normal levels and a gauge of bank capital and funding more suited to the new market conditions, it's difficult to get a sense of where ESNs might price and whether the effort – and cost – they will demand will be justified.

A key imponderable at this point is whether the ultimate design of ESNs and their regulatory treatment leave sufficient value for issuers and investors in the emerging pricing paradigm. Or whether the regulatory ulterior motive of ensuring covered bond differentiation ends up creating a tool that has such a narrow application that it undershoots the business case for banks, fails to create a properly differentiated pricing point for investors, and by extension fails the core goal of facilitating bank lending to the real economy.

"ESNs involve high levels of complexity as well as high levels of management attention due to the shorter life of SME assets and the need for constant replenishment. They will demand high protection in the form of over-collateralisation, as default risk is higher and exposures are typically uncollateralised," said Karlo Fuchs, head of covered bonds at Scope Ratings.

"One of the known-unknowns is the evolution of the costs associated with issuing this secured instrument versus ABS and unsecured debt. At this stage, the spread compression the market has seen is not helpful, as the pricing distinction between unsecured and secured debt is not high enough to warrant the extra effort of creating an additional secured funding channel.

Efficiency considerations do not favour ESNs

"Depending on the issue of regulatory recognition, returns for investors could be lower than for unsecured debt if investors have to attach the same risk weights. Finally, more work is needed on investor demand. What kinds of investors are ESNs best suited to? If they are not eligible for LCR purposes, banks won't buy them, leaving the heavy lifting to asset managers and other institutional buyers," Fuchs said.

"And they are definitely a credit product not a rates product. Investors managing a portfolio of ESNs require a different skill-set, and portfolios require higher attention – not necessarily compensated by higher spreads. Taken in the round, efficiency considerations do not currently favour ESNs."

The EBA is aware of the intrinsic challenges for ESN. It concludes that only when accompanied by a favourable regulatory package as well as ECB repo treatment might the product become viable.

Asset encumbrance and core features

Asset encumbrance no cause for real concern

Asset encumbrance will clearly increase in the event of ESN take-up – potentially disadvantaging unsecured creditors. But the EBA believes this would only be +1.2 to +4.1 percentage points relative to the 26.6% December 2016 sector-level ratio. The EBA believes that the emergence of a functioning new secured funding class could improve the risk profile of issuers. It recommends that if ESNs become successful, aggregate level (not instrument level) asset-encumbrance limits could be worth considering. Otherwise, ESNs should be governed by strict eligibility criteria:

- Non-defaulted loans/leases only as cover assets; robust underwriting standards
- Granular pools with at least 500 exposures
- A 2% cap on exposures to a single obligor
- Minimum 30% OC
- No preferential risk-weights based on the performance of the underlying assets
- Differentiated treatment relative to unsecured exposures
- No preferential treatment under LCR (in the absence of liquidity metrics)
- Preferential investment threshold under UCITs (under certain circumstances)
- Exemption from EMIR collateral posting
- Exemption from bail-in (comparable to secured liabilities for BRRD purposes)

Over-collateralisation

Could there be perverse incentives with 30% OC?

The optically high recommended 30% minimum OC, broadly consistent with credit enhancement levels of senior tranches of SME ABS, was set owing to the default characteristics of SME loans. Even though high OC levels can be mitigated for ratings purposes by conditional pass-through or soft-bullet structures, the general market feeling is that this is too high, bearing in mind the short tenor of SME loans relative to residential mortgages and lower refinancing risk.

"30% is much too high for good pools and possibly too low for bad pools. In fact, it could create perverse incentives, encouraging poor high-risk originators to issue tranches with "only" 30% OC while it will be seen as punitive for good pools and will dissuade strong issuers from looking at this market," said Guillaume Jolivet, head of structured finance at Scope Ratings.

"On the other hand, given the difficulties in setting adequate criteria, the much higher default rates of SME loans relative to prime mortgages, and the managed and continuously replenishing nature of the cover pools, I can understand where the 30% comes from. This is about buying the confidence of the market by shooting for the safe end," Jolivet added.

"The equivalent of a 30% OC protection in an SME ABS very likely equates to a Triple A in most cases, and this is where the EBA clearly feels comfortable in recommending preferential risk-weights. In jurisdictions like Spain and Italy, that level may be justifiable but in less volatile jurisdictions such as France and the Netherlands, 30% could be conservative."

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
33 rue La Fayette
F-75009 Paris

Phone +33 1 82 88 55 57

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer