Making the case for European Secured Notes as an EU safe asset

European secured notes (ESNs) have repeatedly been singled out as one of the tools that can support the Covid-19 economic recovery. In September, the European Parliament's ECON committee asked the European Commission to come up with legislation to establish the instrument to ease bank funding for small and medium-sized enterprises. As an EU safe asset, ESNs could gain more traction.

The appeal of covered bonds as a high credit quality and reliable funding tool for banks in times of crisis has created a lot of interest among policymakers over the years. Covered bonds provide capital market access for issuers when other financing channels have dried up; they also provide alternative, non-capital market-driven central bank funding.

Today, covered bonds are an integral part of the ECB's asset-purchase programmes set up to inject liquidity into the market and ultimately stimulate the economy. ECB holdings under the Covered Bond Purchase Programme (CBPP) approached EUR 300bn in September 2020. Covered bonds also provide issuers with access to central bank liquidity under standard as well as targeted long-term refinancing operations (TLTROs). At the end of Q2 2020, covered bonds' use as collateral with the ECB reached EUR 575bn – the highest in history.

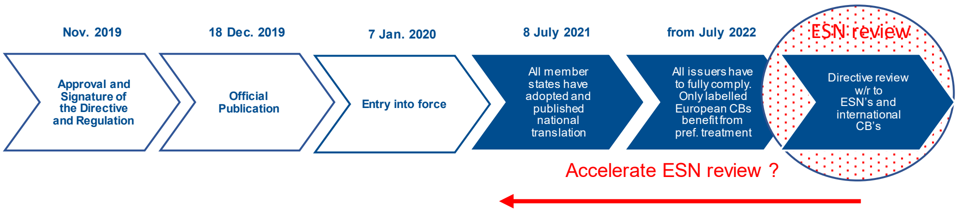
The high usage and efficiency for banks has placed covered bonds firmly under the spotlight for policymakers. Even more so as covered bond harmonisation has been among the few achievements of the European Parliament's Capital Markets Union (CMU)[1].

European Covid-19 recovery is dependent on strong SMEs

Recovery from the Covid-19 crisis will hinge to a large extent on having a strong small and medium sized enterprise[2] (SME) segment. With 99% of all enterprises within the EU[3] and about two thirds of employees working in this sector, they represent the backbone of the European economy. As such, it should come as no surprise when arguably the most successful private capital market product – covered bonds – is looked at as a means to support SMEs.

As part of European covered bond harmonisation, ESNs were initially put on the backburner until 2024. Covid-19 might change this, however. In September 2020, the European Parliament's ECON committee asked the European Commission to come up with a legislative proposal for ESNs to help financing the recovery from the pandemic.

Figure 1: Current timeline European covered bond harmonisation



Source: Scope, EC

[1] EU 2015/ 2634, see here
[2] The European Commission defines SMEs as having fewer than 250 employees, up to EUR 50m turnover or a balance sheet of no more than EUR 43m.
[3] Based on Eurostat, see here

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EBA sees merit to further investigate ESNs

Sufficient SME collateral across Europe could allow for a new asset class…

In the run-up to covered bond harmonisation, the EBA indicated the merits of ESNs and suggested a continuation of the harmonisation path to establish legislation supporting an ESN funding option alongside traditional covered bonds. Based on an estimated EUR 4trn potential volume of SME loans across Europe, it estimated a potential size of an ESN market between EUR 400bn to EUR 1.12trn, roughly 50% of the traditional European covered bond market.

…but acknowledges higher risks need more protection

Based on assumptions on potential cover pool eligibility criteria as well as proxies for default and loss rates among the typical SME exposures (both unsecured and secured), the EBA came up with minimum over-collateralisation of 30%.

…but comparatively higher risk needs to be mitigated

The already higher regulatory over-collateralisation for ESNs – which for rating agencies might need to be topped up to achieve and maintain highest credit ratings – needs to be funded on an unsecured basis by banks, counting against their efficiency. Also, the higher maintenance costs for banks need to be considered. SME cover pools might be fully replenished every second year, but cover pool management i.e. exchanging SME loans that are no longer eligible should not be under-estimated as it adds challenges to economic viability for issuers. At best, meagre funding advantages compared to unsecured funding will be balanced by internal and external maintenance costs.

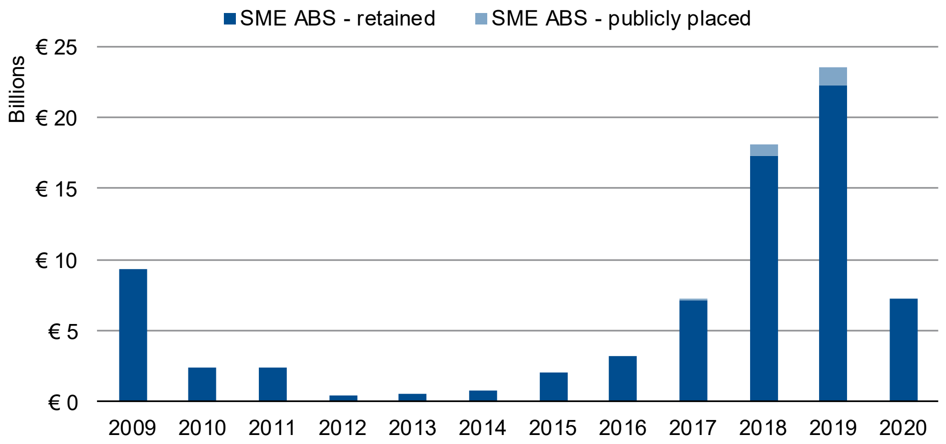
Current SME ABS and ESN – lookalike structures

Traditional SME ABS might be expected to be the natural choice to fund SMEs in the capital markets. ABS can provide funding for banks, take credit risk off the balance sheets of originating banks, and can also be tailored to the risk appetite of investors.

Most SME ABS structures have been retained issuances

However, public issuance of SME ABS in recent years has been meagre at best. The EUR1.2bn placed with investors in 2019 was the largest volume in the past decade. With 97%, almost all SME ABS are issued in retained format only.

Figure 1: SME ABS issuance



Source: JP Morgan Research, Scope

SME covered bonds have not been a success – so far

Covered bond lookalike SME-backed dual-recourse instruments (ESNs) were planned as pure funding products. Transactions to-date seem to have mostly been one-offs, however. The most prominent attempt was Commerzbank's SME-backed structured covered bond programme established in 2013 but fully repaid in 2018. A less visible but also no longer used set-up were French ESNIs.

French ESNI replicated the French SFH structure for SMEs

French ESNI: The most active ESN-like structure to-date has been the French "Euro secured Note issuer" (ESNI), a multi-issuer SME refinancing platform established in 2014 and supported by the Banque de France. Only five French banks[4] contributed, but by design the ESNI model was open to all French and European banks. Twenty bonds raising more than EUR 10bn were issued but only three remain outstanding.

Established dual recourse to the originator and an SME pool

But no preferential treatment for investors

Banque de France acted as gatekeeper for the asset quality of the SME loans. Using its rating model (FIBEN) they checked whether they complied with the minimum requirements for non-marketable credit claims – which they would also individually accept as collateral for repo operations. The scoring, in combination with the standard haircuts applied to such assets allowed the establishment of a transparent (but mechanistic) minimum over-collateralisation to which investors would have recourse. Each bank pooled the loans in a dedicated compartment and investors only had recourse to the originating bank as well as the respective loans in case of a bank default.

Using the blueprint of French mortgage covered bond companies (SFHs), the ESNI managed the issuance only while the loans remained managed (and on the balance sheet) of the originating banks.

Italian OBC legislation ticked most boxes but was never used….

Italian OBC: Italian regulators provided domestic issuers with the ability to issue Obbligazioni Bancarie Collateralizzate (OBC), which would have become the first-ever UCITs-compliant SME covered bonds – with preferred risk weightings and non-bail-in-ability. The Bank of Italy did not appear to have ever published secondary legislation and as such OBC remained an option only. Italian banks did not voice strong support either

…. also in Spain SME covered bonds did not appear

Spanish securitisation framework: Similarly, Spanish legislators kept the door open to SME covered bonds when they amended the Spanish securitisation framework in 2015. The ability of an SPV to provide a guarantee opened up SME-backed covered bonds based on the structured covered bond blueprint. But abundant liquidity since then never prompted a Spanish SME covered bond to surface.

Rationales for ESNs and similar structures seem plausible at first glance. They have not gained traction, however. Could further harmonisation and collaboration help establish ESNs in their current form as an additional on-balance sheet funding instrument and help establish them as a vibrant new asset class?

Pure funding-targeted ESNs not likely the panacea to maintain SME funding in times of stress

We do not expect pure funding targeting ESNs to be the perfect tool to maintain SME funding when the credit tide turns. While ESNs might eventually still be able to provide a bank with funding (if ESNs become repo eligible with central banks), the willingness to maintain such a product will become more challenging for individual banks.

SMEs' increasing capital consumption in a downturn could dry out new issuance

As seen in the current Covid-19 environment, IRFS 9 provisioning rules require banks to beef up provisions. When exposures move into different IFRS 9 classification buckets, weakened SME exposures will eat into bank profitability as well as capital. Sizable pools of SME loans bear the risk of spiralling capital consumption and efficient capital management. For example, out-placing risks via securitisations will not be possible if such loans are encumbered in an ESN cover pool.

[4] BNP Paribas, BPCE Group, Crédit Agricole Group, HSBC France and Société Générale

ESNs 2.0: EU ESNs?

When the ESN idea was floated first, two options were presented as alternatives:

- ESNs as a funding tool that mirrors today's common covered bond structure with a different asset type (i.e. dependent on the legal framework either as an on-balance sheet or SPV set-up)
- ESNs as static and amortising dual recourse SME ABS – providing capital relief

ESN discussions mostly focused on funding support

Most efforts have focused on the viability of the first option, but we do not believe the challenges of single-name ESNs – in particular for smaller and weaker banks – would really help maintain SME funding in more economic challenging conditions.

Improving support for European SMEs is one of the pillars of the EUs CMU action plan. In addition, size and liquidity were cornerstones of the success of (traditional) covered bonds. Why not try to combine both to create a new safe asset for the EU in the form of EU ESNs?

US government SBA loans as a blueprint

The Small Business Administration (SBA)[5], an agency of the US Government, could provide a blueprint. Among the multiple support options, they provide for SMEs (from equity support to funding to counseling) is the 7(a) loan guarantee programme.

Pooled US SBA loans as a blueprint?

SBAs can provide both funding and capital relief

This programme allows banks to extend loans to eligible SMEs[6] for which they need to pay a servicing and a guarantee fee. Depending on the size of the loan granted, the SBA guarantees between 75% and 85% of the loan– effectively providing capital relief and funding to the banks. Eligible collectors pool SBA loans from multiple banks and place them in the market. Because of the full-faith agency guarantee, timely and full payment of the bonds is ensured, so their credit risk is equal to US Treasuries. Even though they have some specific risk characteristics[7], SBA loans are a sought-after investment that banks also can use in their liquidity management. As the originating bank maintains a residual equity stake, adequate underwriting and servicing is ensured.

EIF already provides guarantees for SME loans

SME initiative provides capital relieve but not funding

With the European Investment Fund (EIF) SME initiative[8], support for SME funding has already become reality in some EU member states. Back in 2015, the first uncapped Guarantee Instruments were issued to support Spanish banks' SME lending. Since then, the synthetic structure has also been implemented in Bulgaria, Finland, Italy, Malta and Romania.

Under the SME initiative, banks can identify SME loans originated in the normal course of business. They have to pay a guarantee fee for those loans and the structure provides 50% loss coverage. Because of the guarantee provided, banks can free up capital, shield their P&Ls against losses and provide additional SME lending.

The initiative[9] is managed by the EIF but the guarantee is provided by European Union, the European investment bank, and, for the Spanish initiative, by the Kingdom of Spain.

[5] "Small Business Administration: A Primer on Programs and Funding", August 2020 available here. The mission of the SBA is to "to maintain and strengthen the nation's economy by enabling the establishment and viability of small businesses"
[6] Eligibility criteria for SME loans are not very strict. Their size should not exceed USD 5m and depending on the use have different maximum maturities
[7] Due to the ability of borrowers to prepay, SBA bonds can be repaid at par. Often trading at the premium, investors' main risk is the assessment of prepayment risk but not credit risk
[8] https://www.eif.org/what_we_do/guarantees/sme_initiative/
[9] For the rating report on the Spanish SME initiative see here

The Initiative features some aspects common to covered bonds. It established specific criteria for eligible loans. Combined with the remaining equity stake and the loss-sharing mechanism with the guarantor, it establishes an alignment of interest and avoids moral hazard vis-à-vis originating banks.

Standardisation key for success

The set-up of the initiative also addressed up front some critical aspects for a successful instrument. The European Commission and EIB provided an efficient and standardised template for the Agreement[10]. State aid questions had already been addressed and in its role as manager, the EIF maintains an effective "supervision" of originators' policies and procedures. In addition, a uniform assessment of the reference pools of the contributing member banks is performed to assess the credit quality of the portfolios.

Usage of the initiative by Spanish banks had been strong. With nine banks participating, the reference portfolio for the synthetic structure provided a good representation of the credit quality of the whole Spanish SME sector.

While the programme has been effective, the Spanish initiative had a limited replenishment period and is now in its amortisation phase. Even though the SME initiative expanded and has become established in additional countries, the Spanish SME initiative shares the fate of the Commerzbank SME covered bond – it remained a successful but one-off exercise.

EU ESN 2.0 needs to address some challenges….

Putting the pieces together

To avoid EU ESN 2.0 becoming a one-off, it should address the following factors:

- Provide a clear and transparent guarantor structure similar to the EIB initiative. Such a guarantee could allow for preferential risk weightings and, depending on the guarantee, also support highest ratings in itself;
- A directive-based but locally implemented ESN law could facilitate a high degree of standardisation and harmonisation of underlying collateral and clarify transfer mechanisms as well as roles and responsibilities;
- Pooled, single-country structures could support collateral pool diversification and allow for regular issuance and secondary market liquidity;
- A sufficiently flexible structure which allows for pool replenishment and issuance of bullet bonds should be targeted. Because of short SME loan tenors and regular refinancing, amortising bonds would fall below minimum issuance volumes needed for ongoing high LCR value for investors[11];
- To become an integral part of the CMU, referenced SME loans should benefit from potential funding advantages;
- Strong and ongoing alignment of interest between contributing or pooling banks including dynamic guarantee premiums. To avoid moral hazard, premiums need to reflect the risk of the contributing bank rather than mechanistic levels. Additional risk retention by the issuer could help maintain ongoing high origination standards and effective work-outs;
- Third party monitoring of minimum standards and transparency for investors.

We believe ESNs 2.0 that combine a funding platform with a European guarantee structure could address all of the above and help establish a true Euro SME funding platform.

[10] The structure contains eligibility criteria with regards to the credit quality, maturity and concentration of the portfolio and applied common definitions for of i.e. delinquencies, restructurings, or subjective defaults, among others.

[11] Early repayment would require investors to take a view on prepayment speeds – an important pricing consideration

...But standardised EU supported ESN structures…

Establishing a joint European funding platform that allows pooling of SME lending retaining skin in the game for originating banks and offering protection via an EU guarantee could go a long way to establishing a new high credit quality asset class. Adding ESG or green eligibility criteria to some pockets of SME loans could also make them part of the European Green deal and provide further support to such a structure.

Regular and jumbo issuance could lead to a vibrant secondary market, which would facilitate usage of ESNs as high quality and liquid collateral that banks can use to manage their LCR requirements. Central bank eligibility would boost their acceptance. In addition, using securitisation techniques to out-place some of the residual risks borne by the EU as guarantor could provide investors with access to either European SMEs as a whole or at least truly diversified single-country SME risk.

...could provide a new EU safe asset class

The Capital Markets Union aims to expand European capital markets and bolster SME financing. If all existing pieces available today are combined and cast into a strong framework, European Secured Notes could deliver this promise.

ESNs could establish themselves as an EU safe asset and an internationally sought-after asset class sitting alongside but not compromising traditional covered bonds.

Making the case for European Secured Notes as an EU safe asset

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