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European Secured Notes — Coming to a Bank Near You?

The bank-funding instrument is designed to unlock liquidity for SME loans.

Key Points

- The impact of COVID-19 on European small and medium-sized enterprises (SMEs) is expected to be severe[1] — further underscoring the business case for a diversity of instruments designed to stimulate access to financing for SMEs.
- European Secured Notes (ESNs) are a bank-funding instrument typically issued or guaranteed by a credit institution and further backed by a pool of on-balance-sheet SME loans. Several national jurisdictions and issuing banks have led "test cases" for ESNs that offer helpful insights that could inform the final product guidelines to be adopted by European regulators.
- A common regulatory framework for ESNs, promulgated by the European Commission (the Commission) and endorsed by the European Parliament, could provide further firepower for SME loan origination by European banks and potentially facilitate access to the US market.

ESNs: A lifeline for SME financing amid COVID-19 recovery?

SMEs employed 67% of all persons employed in the EU's non-financial business economy in 2017, according to Eurostat.[2] Further, the Commission reports that the EU's 25 million SMEs represent over 99% of non-financial-sector businesses and account for three-fifths of the value generated by the non-financial business sector.[3] COVID-19 has had, and will likely continue to have, a major impact on the results and financial condition of SMEs and their ability to continue as financially viable business entities.

SMEs represent a class of borrowers that tend to have higher origination costs, higher default rates, and less comparable data sets regarding credit worthiness than other types of borrowers/asset classes, such as real estate mortgages, public entities, and large corporate entities. Borrowers that default on their loans or request other forms of relief will likely impact the capital requirements and financial strength ratios of European banks — which may in turn reduce those banks' ability to lend to SMEs.

ESNs are bonds issued by credit institutions that are secured by a fixed or dynamic cover pool of loan assets. The cover pool serves as a credit enhancement and does not replace the full claim against the issuing bank. Furthermore, the loan assets secured in the cover pool are segregated from the bank's loan book, therefore insulating the cover pool loans from the bankruptcy of the issuer and the claims of other creditors.

The current bank-funding market includes, among other things, additional tier one securities that are quasi-equity, senior unsecured bonds, and covered bonds secured by residential and commercial mortgage loans or certain loans to public entities. ESNs are designed to fit in between the senior unsecured bond market and covered bonds, and alongside cash and synthetic SME securitizations, delivering a cost of funding that is between the pricing of these two instruments while supporting SME loan underwriting. The European Union covered bond market was estimated at €2.1 trillion as of December 31, 2018, with €417 billion issued in the year ended December 31, 2018 (both figures include the UK).[4] The European Banking Authority (EBA) estimated an SME ESN market size of €310 billion to €930 billion.[5]

Existing legal and contractual frameworks for ESNs

The Commission first proposed ESNs as a financial instrument to be issued by banks and backed by SME loans and infrastructure assets as part of the Capital Markets Union (CMU) in June 2017. The Commission, the EBA, and other market participants are focused on developing a common framework for ESNs, along the lines of regulatory alignment on covered bonds and securitization.

Below is a summary of the existing legal and contractual frameworks for ESNs that have been tested in Germany, France, and Italy:

Germany: SME contractual covered bond

In 2013, a German commercial bank issued €500 million in aggregate principal amount of SME structured notes, which were guaranteed by a special purpose vehicle (SPV) that, through a process of true sale, would acquire and maintain a dynamic cover pool portfolio of SME loans from the issuing bank, as well as certain other eligible investments. The structure did not qualify as a covered bond under Germany's Pfandbriefe legislation and so was technically a structured note. The SME contractual covered bond structure featured an overcollateralization of 121% and a pass-through structure, meaning that so long as the issuing bank made payment of interest and principal on the notes, the cash flows from the cover pool were released to the issuing bank. The bankruptcy remoteness of the cover pool was additionally enhanced by recording the transferred assets on the Refinancing Register (*Refinanzierungsregister*), which, pursuant to German law, provides a statutory means of segregating the loans provided as collateral (including in a contractual cover pool) from the assets of the issuing bank. Recording the transferred assets on the Register also protects such assets from claims by other creditors of the issuing bank in the event of the bank's resolution/insolvency — a method that has been used in structured financing transactions. Ultimately, the issuing bank decided not to continue with the program, and the notes were repaid at their stated maturity in 2018. Still, the ongoing reporting structure that was prepared could provide a useful blueprint for the ongoing disclosure of ESNs.

France: Asset-backed securitization platform

In 2014, several private French banking groups, with support from the Banque de France, launched a multiple bank-funding platform open to all European and French banks, the Euro Secured Notes Issuer (ESNI). The ESNI uses a securitization-like SPV to issue notes secured by identified bank loans to SMEs originated by its member institutions that satisfy all Eurosystem eligibility criteria for credit claims collected from a pool of private lenders and are themselves Eurosystem eligible.[6] The instruments are known as DECCs (non-marketable debt instruments backed by eligible credit claim). In addition to being secured by a pool of SMEs, they also give noteholders a double right of recourse against the credit institution that originated the loans and against the loan pool.

ESNI was established as a securitization company under French law and is open to all French and European credit institutions that meet the criteria for eligible counterparties for the Eurosystem.[7] The ESNI vehicle consists of segregated compartments, and each eligible bank is granted access to its own compartment. The compartment, rather than the banking institution itself, issues the securities, which are backed by loans originated by the relevant bank (each receivable is discounted on the basis of the customary rates applied by the Banque de France). The bank also transfers these receivables to the ESNI vehicle via a mechanism of transfer of ownership by way of security (*cession en pleine propriété à titre de garantie*). The loans remain, however, on the originating bank's balance sheet, making the ESNI structure akin to a non-deconsolidating securitization (however, in the case of default of the bank, ownership of the SME loans is transferred to the SPV, in accordance with the French covered bond framework). The DECCS cannot be tranched and are not rated.

As a multiple bank-funding platform, ESNI addresses information asymmetries from the lack of standardized information available to investors regarding the borrowers of the underlying SME loans through utilizing the Banque de France's FIBEN service, which provides credit assessments of non-financial companies as well as internal ratings from banks in order to score the SME loans backing the DECCS. This innovative method for providing standardized data on creditworthiness highlights the need for a coordinated approach to create a funding market that can permit investors to construct portfolios with exposure to different sectors and SME loans of varying underlying credit qualities and could serve as a case study for developing a European-wide ESN product.

Italy: Legislative path towards ESNs

Law Decree No. 18 of February 14, 2016, converted into law as Law No. 49 of April 8, 2016 (the Banking Decree), created a new instrument class known as collateralized bank bonds (*obbligazioni bancarie collateralizzate* or OBCs), which resemble ESNs. OBCs are notes issued by banks that are guaranteed by an SPV that holds, following true sale by the originating bank, a cover pool made up of bonds or other debt securities, ship mortgage loans, SME loans, and leasing or factoring liabilities or securitized notes of any of the foregoing asset classes. The Italian government promulgated the Banking Decree during a period when certain Italian banks had difficulty accessing the capital markets for senior unsecured debt securities. The key feature of the Banking Decree was to formally place OBCs under public supervision by the Bank of Italy, therefore making OBCs eligible for favorable regulatory and prudential treatment by both issuers and investors. The legislator's goal was to promote OBCs as a funding instrument for smaller banks that might not otherwise have had access to the then-applicable national covered bond framework, which required compliance with a total consolidated capital ratio of 9% to obtain a license from the Bank of Italy to issue covered bonds.[8] However, although the legislative framework for issuing OBCs has been established since 2016, no issuances have taken place, largely because banks have focused on de-risking transactions in the form of securitizations.

EBA Recommendations for SME ESNs

The Commission formally requested a report from the EBA setting out recommended product standards for ESNs, which the EBA delivered in June 2018. The EBA's recommendations[9] concerning the creation of ESNs borrows heavily from the success of the European Covered Bond Framework[10] and specific product features of that instrument.[11] The EBA recommends that ESNs should be dual-recourse instruments, meaning investors have a priority claim over the loan portfolio securing the ESN (cover pool) and a direct claim against the bank that issues, or guarantees, the ESN (depending on applicable law). However, the EBA determined that infrastructure loans are too complex and heterogeneous to support credit enhancement of ESNs, and instead concluded that a standardized EU infrastructure bond would be more appropriate than an ESN for infrastructure assets.

The differences between SME and residential and commercial mortgages and public loans parallels the differences between SME ESNs and the European Covered Bond Framework. Below are some of the differences:

- SME loans have, on average, higher rates of default and are much less uniform than mortgage loans.
- Information on the credit performance of SME loans is not standardized, making it more difficult for lenders and investors to accurately assess and compare the quality of these loans.
- SME loans are frequently unsecured, and unlike with mortgages, lenders cannot use a loan-to-value ratio test to evaluate risk associated with these assets.[12]

The EBA provides specific product standard recommendations on how to adapt the covered bond model to the unique characteristics of SME ESNs in order to mitigate the risks that the above differences present. While it was originally considered that infrastructure financing in Europe could also be stimulated through a dual recourse covered bond-like instrument, the EBA recommended against establishing such an instrument. Instead, the EBA recommended a single recourse infrastructure bond secured by a static pool of assets.[13]

Product standard recommendations

The EBA sets forth the following product standard recommendations for SME ESNs:

- The underlying borrower in each of the loans in the ESN cover pool should be an enterprise with an annual turnover not exceeding €50 million.[14]
- Only registered EU credit institutions may issue ESNs.[15]
- ESNs should be bankruptcy-remote,[16] and creditors should have dual recourse to the bank and the cover pool.
- The cover pool should:
  - Be segregated[17] and unencumbered by third-party claims
  - Comprise assets located within the European Economic Area (EEA)[18]
  - Reflect exposures to at least 500 borrowers
  - Have a minimum overcollateralization of 130% of the ESN's principal and interest[19]
  - Be limited to non-defaulted SME loans and leasing exposures of only one asset class[20]
  - Be dynamic, i.e., adjusted periodically in accordance with the above eligibility criteria throughout the lifetime of the ESN[21]
- The issuer must establish a liquidity buffer.[22]

The implications of the EBA's product standard recommendations are to firmly situate SME ESNs as investments with minimum credit quality principles and provide a floor for minimum harmonization of credit enhancement, notwithstanding that the underlying SME loans and leasing exposures are inherently different from sector to sector. The insolvency law regime and related recovery may also significantly vary among EU Member States.

Supervision and reporting recommendations

The main takeaways from the EBA supervision and reporting recommendations are as follows:

- Each Member State should designate a competent authority or authorities to grant permission for ESN issuances; monitor compliance of ESN programs; supervise, investigate, and sanction ESN-related matters in accordance with the regulatory ESN framework that is established; and take relevant action in the context of an insolvency or resolution of the issuer, similar to the European Covered Bond Framework.

- Unless a Member State competent authority monitors the cover pool directly, a cover pool monitor should be appointed that is independent of the credit institution and its audit firm. This is a divergence from the European Covered Bond Framework, which sets out that Member States may impose this additional requirement.[23]

- Issuers should conduct periodic stress tests on the cover pool to assess the implications of key risk factors on the coverage and the ESN program's capability to make full and timely payment of the note.

- Issuers should provide initial and quarterly reporting to investors regarding, among other things, information on the number of loans in the cover pool, the exposure value of and the original tenor of each loan, the field of the industry in which the borrowers operate, and the location of the assets, as the cover pool is dynamic.

The reporting recommendations are in line with those of the European Covered Bond Framework and represent a lighter version of standard information undertakings typically made in connection with securitization notes issued pursuant to the Securitisation Framework.[24] The dual-recourse nature of the ESN mitigates against the more granular disclosure. If implemented, the EBA's recommendations will likely facilitate the attractiveness of the instrument as it would be easier to administer and would not require banks to obtain waivers of confidentiality from their borrowers or to put in place cumbersome internal data collection processes.

Regulatory treatment and its benefits for investors

Credit institution investors

In light of the increased risk profile of SME ESNs, the EBA assumes that ESNs will likely have a higher risk weight than covered bonds, which will impact their regulatory treatment. With respect to capital requirements, unlike traditional covered bonds, SME ESNs should not receive preferential treatment based on the performance of the underlying assets, since SME loans are not secured by a standardized underlying security, as is the case with mortgage loans. However, a differentiated risk-weight treatment could be considered for SME ESNs subject to certain conditions that would assist in mitigating the risk. If these conditions are met, ESNs would likely have a higher risk weight than covered bonds, but would benefit from a lower risk weighting than unsecured bonds.[25] If the investor obtains an investment with lower capital costs and greater liquidity than through direct ownership of the SME loans, that could have the attendant benefit of reducing costs for SME financing, similar to the way that covered bonds and securitizations can reduce mortgage rates.

UCITS investors

The EBA recommends that SME ESNs qualify for preferential treatment under Directive 2009/65/EC of July 13, 2009 (the UCITS Directive), the legislation that sets maximum exposures to particular asset classes by funds seeking to operate in the EU on the basis of a single authorization. Generally, bonds are subject to an exposure limit of 5% under the UCITS Directive; however, UCITS can invest up to 25% of assets in eligible covered bonds under certain circumstances.[26] The EBA also recommends that SME ESNs receive more favorable UCITS investment limits. Additionally, as secured liabilities, governed by specific legislation (in particular, if the framework receives European Parliament approval), SME ESNs would be exempt from bail-in.[27]

Insurer investors

Although the EBA does not take a position as to whether the insurance regulatory capital treatment of SME ESN's in the context of Solvency II should be changed, it does view the insurer investor base as particularly well-suited to fund SME lending and suggests that the European Insurance and Occupational Pensions Authority (EIOPA) assess the potential regulatory treatment of ESNs for insurers. The EBA suggests that the proposed treatment of investment by credit institutions in ESNs under the CRR as between covered bonds and direct issues by credit institutions should provide some guidance on whether the spread risk factor for insurers applying the standard model under Solvency II might be reduced.

Derivatives hedging cover pools

The EBA suggests that, provided sufficient levels of overcollateralization are in place, ESNs with product standards similar to those of covered bonds and meeting all the additional EMIR criteria for covered bonds should be exempt from posting initial and variation margin under the European Market Infrastructure Regulation (EU 2016/2251)(EMIR), as is the case for covered bonds.

Eurosystem eligibility

ESNs, assuming they are eligible collateral for the Eurosystem, can be more resilient during periods of financial stress than securitizations, which tend to have static underlying asset pools — the EBA recommendation would require dynamic cover pools for ESNs with frequent stress testing, which would in turn make it a more attractive instrument for investors.

Additional structuring and disclosure considerations

Covered bonds celebrated their 250 years of existence in 2019 — this instrument was developed in Prussia and was refined over the successive decades, with national law leading the charge. Certain innovation for ESN-like products has already been brought to market as discussed above under "Existing legal and contractual frameworks for ESNs".

Below are a few additional considerations that will reduce time to market and open the Rule 144A and Section 4(2) markets for sale of ESNs in the United States pursuant to an exemption from the registration requirements of the US Securities Act of 1933.

EU-wide market

One of the main achievements of the European Covered Bond Framework is the creation of an EU-wide marketplace for covered bonds that establishes minimal technical and legal requirements for covered bonds, facilitating the ability of investors to gain exposure to mortgage and public entity loan assets across Europe. If ESNs were to follow this template and, building on the innovation that has already occurred in certain Member States, establish common technical and legal requirements and product standards for ESNs, the instrument could become an additional tool in the kit for bank funding with the attendant benefit of potentially lower cost of funding for SMEs.

Issuance Framework

As the European Union begins to shore up its economy and facilitate access to liquidity for SMEs, it is important that the ESN market quickly reach an economy of scale Covered bond innovation evolved first at the national level and then at the contractual level, with issuers fashioning their own covered bonds (including one that was secured by an SME loan cover pool in 2013), but given the urgency to finance SME recovery and continued growth in order to achieve the CMU, SME ESNs should be established through a common, transparent framework at the EU level.

Disclosure

The Rule 144A (qualified institutional buyers) and Section 4(2) (accredited investor) markets are the most achievable distribution destinations for ESNs as they represent large and liquid pools that have historically invested in European bank instruments. Since the US public market generally requires that instruments offered publicly comply with the disclosure regime set forth in Regulation AB (now Regulation AB II) applicable to asset-backed securities, the more granular loan-level of disclosure required for public offerings would likely not be attractive or appropriate for ESNs. Existing covered bond and SME structured notes disclosure provide a good basis for ensuring that investors have sufficient information regarding the state and credit quality of the SME loan cover pool, which would comply with the disclosure standards of the US market.

Investment Company Act

In order to readily access the US market, covered bonds must be exempt from the registration requirements of the US Investment Company Act of 1940 (Investment Company Act). When the European Covered Bond Framework was passed, it recognized that two models for covered bonds existed in national legislation: (i) the “one-tier” structure prevalent in Germany, France, and Spain whereby the covered bond is issued directly by the bank issuer or specialized mortgage company and the cover pool remains on balance sheet but legally segregated, and (ii) the “two-tier” structure prevalent in the United Kingdom and Italy, where the covered bond is issued by the bank and guaranteed by an SPV that holds the cover pool via a true sale or equitable assignment. The Commission has an opportunity to establish a model that is off-the-shelf ready for the US market through endorsing a one-tier approach for ESNs, which would permit covered bonds to be sold in the US market under a Rule 3a-6 Investment Company Act exemption for non-US entities regulated as banks that are “engaged substantially in commercial banking activity”.

Conclusion

As part of the economic stimulus related to the post-COVID-19 period in the European Union, the Commission may seek to promote policies that will further unlock credit for the SMEs, which form the backbone of the labor and value marketplace.

At the time the Commission finalized the European Covered Bond Framework, it indicated that it would reassess the case for ESNs in 2021, two years after implementation of the European Covered Bond Framework. However, in light of the current crisis related to COVID-19, it may be fitting to revive these discussions given that non-performing loan exposures and a recessionary environment will likely exert pressure on European banks’ ability and willingness to lend to SMEs, and both SMEs and investors would benefit from a dual recourse instrument that is eligible collateral for central bank repo facilities.

A working group of European Parliament members have recently asked the Commission to draft legislative proposals for ESNs in light of COVID-19's likely impact on SME lending.[28] Although there is still considerable uncertainty as to the medium- and long-term liquidity position and default rates of SMEs, the CMU emphasized finding additional levers to provide SME funding as a clear policy objective. Certain questions will need to be answered — in particular, whether the intended pricing benefit of ESNs will be achieved in the context of suspension of the insolvency test and/or acceleration moratoria still in place in certain Member States. Additionally, the historic data on SME loan defaults may not be representative of what may happen in the near future, and there is a view that ESNs may be an instrument better suited to support the second phase of the recovery in the medium term.

The Commission has approved various state aid guarantee schemes by which loans to SMEs are guaranteed by Member State governments or state-owned credit institutions up to a stated amount, and has created of a simple, transparent and standardized (STS) framework sought for SME securitizations in order to revitalize the cash securitization market. Meanwhile, the European Central Bank is mobilizing to support liquidity for banks. Lessons from the previous crisis show that "while capital markets can complete the role of bank lending, the challenges of SME financing (especially due to the heterogeneity of SMEs — which at the same time is an important source of attractiveness to private investors — and typically scant credit information) do not allow for complete disintermediation of banks when it comes to the origination of SME loans, given the fixed-cost nature of sourcing and monitoring rather small and mostly local firms".[29]

ESNs would permit European banks to leverage their branch network and utilize their knowledge regarding SME borrowers and underwriting standards while supporting their lending activities with a funding alternative to the senior unsecured and securitization funding markets. As the impact of the COVID-19 crisis is expected to continue to reverberate through the European economy, banks may need the full menu of funding options.

If the past is prologue to the future, the European Central Bank has, for various policy and macroeconomic reasons, chosen to implement quantitative stimulus via purchases of covered bonds, having purchased €120 billion of covered bonds as part of its covered bond purchase programs from July 2009 to June 2010 and November 2011 to October 2012, and having been engaged in a €60 billion to €80 billion covered bond purchase program since 2015.[30] Similarly, in 2015, Germany's state-owned credit institution guaranteed an SME covered bond program (thereby rendering it eligible under the Pfandbriefe legislation as the cover pool benefited from a public sector guarantee). Therefore, a standardized European SME ESN label could become the object of similar initiatives to use purchases or guarantees of such instrument as a means to promote or decrease cost of funding to SMEs.

The investor buy-side community is increasingly endorsing portfolio allocation policies that designate certain assets under management for investing with environmental, social, and governance (ESG) aims. There is potential for SME ESNs to serve as a funding instrument for banks that is aligned with ESG objectives. For example, ESNs provide exposure to a segment of the European economy that traditionally lacks easy access to funding, which could help them receive a social bond label. Additionally, as we are seeing in the energy-efficient mortgage covered bond market, SME ESNs could be arranged to group SME loan portfolios from economically-disadvantaged areas or with borrowers with particular characteristics that carry a social bond label, which could in turn attract investors who take a "double bottom line"[31] approach. Furthermore, given the ongoing push by the Commission towards a new green taxonomy, depending on the issuing bank's underwriting strategy, SME ESNs may be welcomed as yet another sustainable finance instrument that could further leverage private capital for ESG aims.[32]

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Endnotes

1 SMEunited, *The economic impact of COVID-19 on SMEs in Europe,* (June 2020) https://smeunited.eu/admin/storage/smeunited/200630-covidsurvey-results.pdf.

2 Eurostat, *Structural Business Statistics,* (2017 data) http://epp.eurostat.ec.europa.eu/portal/page/portal/european_business/data/database.

[3] European Commission, *Annual Report on European SMEs 2016/2017,* (November 2017) 11, https://www.ggb.gr/sites/default/files/basic-page-files/Annual%20Report%20-%20EU%20SMEs%202016-2017.pdf.

[4] European Covered Bond Council, European Covered Bond Fact Book 2019.

[5] EBA, *EBA Report on European Secured Notes* (July 24, 2018), 2, https://eba.europa.eu/sites/default/documents/files/documents/10180/2087449/6fe04a31-ec0b-4ea1-9508-258ad2cf72d8/EBA%20Final%20report%20on%20ESNs.pdf.

[6] The ESNI remains active, however, there have been only a limited number of issuances since its launch in 2014.

[7] The criteria for eligible counterparties for the Eurosystem is defined in the European Central Bank (ECB) Guidelines ECB/2015/27.

[8] Bernd Volk, *SME Covered Bonds: An Interesting New Format*, EBRD Law in Transition Journal, (2015) 76, https://www.ebrd.com/documents/comms-and-bis/pdf-law-in-transition-2015-english.pdf.

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[10] Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU, OJ L 328, 18.12.2019, p. 29–57 and Regulation (EU) 2019/2160 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds, OJ L 328, 18.12.2019, p. 1–6 (together, the European Covered Bond Framework).

[11] Latham & Watkins *Client Alert*, *We've Got You Covered: New European Covered Bond Framework,* (April 22, 2019) https://www.lw.com/thoughtLeadership/new-european-covered-bond-framework.

[12] For example, the European Covered Bond Framework provides that covered bonds may be backed by loans secured by residential property (with the loan amount capped at 80% of the value of the pledged property), residential loans guaranteed by credit protection providers such as central, regional or local governments and authorities, public sector entities, financial institutions and corporate entities with high credit quality (with the loan amount capped at 80% of the value of the pledged property and where a loan-to-income ratio is capped at 33%), loans secured by commercial property (with the loan amount capped at 60% of the value of the pledged property) and loans secured by maritime liens on ships (with a loan-to-value ratio of at least 60%).

[13] The EBA concluded that the dual-recourse feature would be less suitable to instruments backed by infrastructure loans due to the asset-specific nature and heterogeneity of infrastructure loans, which are typically tailored to the particular cash-generative profiles of specific infrastructure assets (e.g. toll roads, pipelines, etc.) that present different risks and the grouping of loans into a cover pool for one single instrument would result in a complex credit risk profile. Furthermore, the EBA found that dual recourse element would not be well-suited to the relatively high regulatory capital consumption of infrastructure projects that arises from their long maturity profile, the significant exposure amounts and applicable provisioning rules. Standardizing infrastructure bonds in the European Union will likely need to take on a new guise as a result, separate from the ESN product.

[14] Because SME definitions vary between EU Member States, the EBA recommends establishing a common definition for purposes of creating a harmonized SME ESN framework. The EBA further proposes to apply the definition found in Article 501(2) of the Capital Requirement Regulation (CRR), which is already widely applied by EU institutions and will thus be relatively easy to implement. Furthermore, the EBA favored the CRR definition because it would capture a larger number of SME loans than other narrower definitions and its use will ensure that SME ESNs are eligible for preferential prudential capital treatment in accordance with the CRR.

[15] This requirement helps to ensure that ESNs will be eligible for preferential regulatory treatment under the Undertakings for the Collective Investment of Transferable Securities Directive (UCITS), which enables collective investment schemes to operate freely throughout the EU based on a single member state's authorization. Article 52(4) of the UCITS Directive 2009/65 EC sets out the criteria regarding issuing credit institutions.

[16] The EBA recommends that the SME ESN incorporate two key aspects of bankruptcy remoteness, similar to the covered bond framework, including that: (i) the ESNs should not be subject to automatic acceleration of the outstanding repayment of the note and investors should be ensured a preferential claim in the SME cover pool, and (ii) operational procedures should be put in place by the issuer to ensure that a seamless transition of duties can take place from the issuer to the administrator in the case of insolvency.

[17] Segregation can be achieved through true sale/pledge or use of the provisions of Directive 2002/47/EC of the European Parliament and of the Council of June 6, 2002 on financial collateral arrangements (the Collateral Directive). By way of comparison, the European Covered Bond Framework permits segregation to obtained through (i) a cover register (essentially a repository of all loans/mortgages that are encumbered in a given cover pool) (ii) transfer to a SPV via true sale or contractual assignment or (iii) segregation in a specialised credit institution (e.g. a specialised mortgage institution), as long as the segregation is binding and enforceable including in the issuer's insolvency or resolution – potentially one or more of the foregoing could be adapted for SME ESNs.

[18] The EBA recommended that cover pool assets should be limited to those located within the EEA in order to ensure that, in the case of issuer default, liquidation of the collateral will be legally enforceable. To that end, although the EBA report does not pass

on this point with certainty, it reasonably follows that the location of the assets and the domicile of the borrower would need to be located within the EEA jurisdiction. The European Covered Bond Framework provides a mechanism for the finding of equivalency for certain jurisdictions that has the potential for cross-border covered bonds to be issued with cover pools containing mortgages from outside the EU, it remains to be seen if such a mechanism will be contemplated for ESNs, though the name of the instrument suggests otherwise.

[19] SME ESNs are thought to require greater overcollateralization as compared to traditional covered bonds, which require a minimum overcollateralization of 105%, because of the increased risk of loss that could be experienced by a portfolio of SME loans as compared to a portfolio of mortgages. The EBA prescribes a minimum 130% requirement because this falls between the observed overcollateralization levels for less risk prone covered bonds (118%) and for asset-backed securities (138%), which tend to carry greater risk.

[20] The EBA recommends a set of minimum conditions for SME ESN cover pools in order to ensure their high quality. In order not to narrow the market unnecessarily, though, the EBA attempts not to be overly prescriptive with its conditions, for fear it would otherwise exclude potentially high-quality loans. It believes that the high level of overcollateralization required for SME ESNs (130%) will compensate any risk arising from the limited set of cover pool criteria it sets out. In addition to the limited asset scope, the EBA also requires that (i) the granularity of the cover pool be sufficiently high, containing at least 500 exposures for risk diversification; (ii) the cover pool should not be subject to material concentration such that the aggregate exposures value to a single obligor in the cover pool should not exceed 2% of the total exposure value of all exposures in the cover pool; and (iii) in addition to the SME loans being non-defaulted, the credit institutions themselves should have well-defined and sound credit underwriting standards.

[21] The EBA recommends a dynamic management of the cover pool to account for the potentially high risk of replenishment unique to an SME cover pool. For an SME ESN, the cover pool is likely to have a short maturity profile such that there is an increased risk that the cover pool is repaid before the maturity of the note. We also anticipate that dynamic management of the cover pool will permit the removal of assets that no longer meet the eligibility criteria for other reasons (e.g. SME loans that default and SMEs with outstanding loans that are purchased by larger-sized enterprises) similar to what currently occurs in the covered bond space.

[22] Liquidity buffer refers to cash and cash equivalents held in a segregated manner that provide additional credit enhancement to the ESN.

[23] Unlike the novel ESN scheme, the covered bond framework developed from hundreds of years of practice over which time standard rules were established, ensuring that covered bonds would already be well-monitored without further oversight. ESNs, however, do not have a history of practice to build upon, and therefore, will require more monitoring from the outset. Italian OBCs were placed under public supervision by the Bank of Italy to guarantee this type of monitoring and thereby ensure more favorable regulatory and prudential treatment.

[24] Latham & Watkins *Client Alert*, *European Commission Proposes Amended Framework for the Securitisation of Non-Performing Exposures,* (September 8, 2020) https://www.lw.com/thoughtLeadership/european-commission-proposes-amended-framework-for-the-securitisation-of-non-performing-exposures.

[25] According to the EBA recommendations, in order for SME ESNs to qualify for a differentiated risk-weight treatment, they should meet the following conditions: (i) ESNs should possess a dual-recourse feature as well as structural and cover asset eligibility criteria that provide sufficient additional credit enhancement to mitigate many of the risks of the underlying SME assets; (ii) ESNs should respect the overall consistency of the CRR capital framework between exposure classes (in particular, the capital treatment of SME ESNs 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 (iii) there should be a clear distinction between the prudential framework of SME ESNs and that of covered bonds in order to differentiate between risk profiles of the two instruments and avoid any market confusion or negative side effects on the covered bond market.

[26] Article 52 of the UCITS Directive sets out minimum requirements for a bond to be eligible under UCITS. Provided that the conditions of Article 52(4) are satisfied, UCITS funds may invest up to 25% of their assets in a given bond instead of 5%. The conditions include: (i) the issuer must be a credit institution, registered in the EU and subject to a special prudential public supervision; (ii) the law must specify which assets can be included in the cover pool; (iii) the cover pool must provide sufficient protection to cover the claims of the bondholder throughout the whole life of the bond; and (iv) bondholders must have a priority claim on the asset pool in case of default of the issuer.

[27] In accordance with Article 44(2)(b) of the Directive 2014/59/EU (the Bank Recovery and Resolution Directive or the “BRRD”), UCITS-compliant covered bonds are exempt from bail-in. Therefore, insofar as SME ESNs will be UCITS-compliant, like traditional covered bonds, they should also satisfy the criteria necessary to be exempt from bail-in. Additionally, ESNs may be exempt from bail-in under Article 44(2)(b) and in accordance with recital 70 of the BRRD if they qualify as secured liabilities where the security covers 100% of the liability.

[28] Tyler Davies, *MEPS call for ESNs as part of new CMU drive*, Global Capital, (September 11, 2020) https://www.globalcapital.com/article/b1nbdh906hfzn9/meps-call-for-esns-as-part-of-new-cmu-drive.

[29] Kaousar Nassr, I. and G. Wehinger, *Unlocking SME finance through market-based debt: Securitisation, private placements and bonds*, OECD Journal: Financial Market Trends, Vol. 2014/2, (2015) https://doi.org/10.1787/fmt-2014-5js3bg1g53ln.

[30] European Central Bank, *Asset purchase programs,* (2020) https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html.

[31] Refers to investors who seek to combine a financial return with a social or environmental return.

[32] See for example, High-Level Expert Group on Sustainable Finance, European Commission, *Financing a Sustainable European Economy,* (January 2018) https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf.