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Shaping the European Secured Notes (ESN) market

Abstract

The article characterizes the process of shaping the European Secured Notes (ESN) market, as a new pan-European capital market instrument for funding banking activities, based on the experience of the covered bonds market. ESN is particularly dedicated to lending to small and medium-sized enterprises. The characterization was structured into four thematic areas, consisting of: the importance of double-recourse instruments, the concept of the new capital market instrument, investors' preferences and the feasibility study of the new instrument. Analyses of literature and empirical sources indicate that the ESN market has significant potential for development due to the business benefits and political support of the EU and its agencies, despite the skepticism of financial market players to date.

Keywords: European Secured Notes, SME, ESG, sustainable economy, Capital Markets Union, covered bonds

JEL Codes: G18, G28

Kształtowanie rynku europejskich obligacji zabezpieczonych (ESN)

Streszczenie

Artykuł charakteryzuje proces kształtowania rynku europejskich obligacji zabezpieczonych (*European Secured Notes*, ESN), na bazie doświadczeń rynku listów zastawnych, jako nowego pan-europejskiego instrumentu rynku kapitałowego służącego finansowaniu działalności bankowej, w szczególności w zakresie kredytowania małych i średnich przedsiębiorstw. Charakterystykę ustrukturyzowano w ramach czterech obszarów tematycznych, na które składają się: znaczenie instrumentów o podwójnym regresie, koncepcja nowego instrumentu kapitałowego, preferencje inwestorów oraz studium wykonalności nowego instrumentu. Analizy literatury i źródeł empirycznych wskazują, że rynek ESN ma znaczący potencjał rozwoju ze względu na uzasadnienie biznesowe oraz poparcie polityczne UE i jej agend, mimo dotychczasowego sceptycyzmu podmiotów rynku finansowego.

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Słowa kluczowe: europejskie obligacje zabezpieczone, MŚP, ESG, zrównoważona gospodarka, Unia Rynków Kapitałowych, listy zastawne

Kody JEL: G18, G28

Introduction

As part of the debate on the Capital Markets Union[1], an initiative of European Secured Notes (ESN) emerged based on the concept of covered bonds as instruments of stable, long-term funding of banking activities. ESNs would enable banks to fund a new class of assets for small and medium-sized enterprises (SME)[2], taking into account ESG (environmental, social, governance) standards[3]. ESN uses techniques[4] and best market practices[5] of covered bonds in a new capital market instrument, which would also be available in situations of market stress or financial crisis, thus acting anti-cyclically.

The ESN project gained importance following the announcement of the European Commission's (EC) Capital Markets Union action plan[6] and due to the possibil-

[1] The Capital Markets Union project aims to facilitate the inflow of investments from other countries to the European Union and the flow and transfer of capital mainly to small and medium-sized enterprises, among others: by increasing financing through capital markets compared to classic bank financing. Rezolucja Parlamentu Europejskiego z dnia 9 lipca 2015 roku *w sprawie tworzenia unii rynków kapitałowych*, 2015/2634 (RSP). Dz.U.UE C 265/09 z 11.8.2017; *Unia Rynków Kapitałowych. Stanowisko Giełdy Papierów Wartościowych w Warszawie S.A. w sprawie koncepcji Unii Rynków Kapitałowych*, Giełda Papierów Wartościowych w Warszawie S.A., 27.04.2015, https://www.gpw.pl/pub/GPW/files/PDF/ Stanowisko_GPW_unia_rynkow_kapitalowych2.pdf (accessed: 28.08.2023).

[2] Unlike mortgage loans, which are the underlying assets of mortgage covered bonds.

[3] Environmental, social and corporate governance criteria are a set of corporate standards used by socially conscious investors to select potential investments. Environmental criteria take into account how a company protects the environment, including, for example, its corporate policy on climate change. Social criteria define how a company manages relationships with employees, suppliers, customers and the communities in which it operates. Corporate governance concerns a company's leadership, executive compensation, audits, internal controls, and shareholder rights. *Environmental, Social, and Governance (ESG) Criteria*, Investopedia, https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp (accessed: 27.08.2023).

[4] In particular, the double recourse mechanism (to the issuer and separated pool of assets), overcollateralization (loans securing the issued covered bonds constitute more than 100% of the issue value), segregation and the requirement of high quality assets (only loans meeting specific quality conditions may constitute collateral and they are separated from the issuer's assets), public supervision (independent supervision over separated pool of assets) and high requirements for information transparency (covered bonds and the loans securing them are subject to high, standardized information requirements) (Dżuryk 2020).

[5] Defined in the Covered Bond Label, which is a kind of quality mark of a covered bond. This certificate was developed by the European Covered Bond Council (ECBC), an organization bringing together the community of European issuers of covered bonds, in close cooperation with investors, regulators and all key stakeholders. *Harmonized Transparency Template*, Covered Bond Label site, https://www.coveredbondlabel.com/htt (accessed: 27.08.2023).

[6] *Capital markets union 2020 action plan: A capital markets union for people and businesses*, European Commission, 24 September 2020, https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan_en (accessed: 27.08.2023).

ity of using this instrument as a tool for rebuilding the European economy after the Covid-19 pandemic, primarily in relation to small and medium-sized enterprises, which constitute the backbone of European economy.

The aim of the article is to characterize the experience of building the ESN market[7]. The study is structured into four thematic areas, which include: the importance of double-recourse instruments, the concept of a new capital instrument, investors' preferences, a feasibility study of the new instrument and the position of the European Banking Authority (EBA) towards the ESN.

The characteristics of the process of shaping the ESN market was developed on the basis of available literature, projects and normative acts of the EU and its agencies, in particular the EBA and the European Covered Bond Council (ECBC), which includes entities that are actively involved in the development of the new instrument.

1. Double recourse financial instruments

As part of the debate on capital flows in the EU, Jean-Claude Juncker, defining the goals for the EC, outlined the concept of creating a Capital Markets Union (Juncker 2016). The main goals of the integration of capital markets are: greater diversification of financing of the European economy and lowering the cost of obtaining capital. In particular, the Capital Markets Union is intended to[8]:

- improving the flow of capital from investors to key areas of the European economy, i.e. start-ups, small and medium-sized enterprises and investment projects;
- increasing market efficiency and financial intermediation in the transfer of funds internationally to companies financing their development, at an acceptable cost and on the same conditions as on the domestic market;
- reducing the risk of transfer and allocation of capital within the European Union to entities that are better able to use it;
- diversifying financing sources and reducing the dependence of the European market on banks, thus increasing its resistance to financial crisis.

The EC has committed to creating the foundations of a Capital Markets Union covering all EU member states, with the primary task of expanding access to long-term financing. It was crucial that the financial sector responded to this initiative by developing appropriate instruments enabling the promotion of stable and safe long-term financing of the economy in the EU.

Initially, it was intended to develop a double-recourse instrument based on the experience of covered bonds, but maintaining their distinct differences. This was based on the high resistance of covered bonds, which was verified macroprudentially in the stressful conditions of the global financial crisis of 2007–2009 (Grossmann

[7] The article is a preview of the monograph on European Secured Notes being prepared by the author.

[8] *The role of Dual Recourse Instruments for Long-Term Finance in Europe*, A. Jobst (ed.), European Covered Bond Council, February 2015, p. 2.

& Stöcker 2015, p. 110–111). While maintaining the integrity of traditional covered bonds as a long-term funding instrument for the banking sector, their selected features were used to develop a new double-recourse instrument. The aim was to expand the sources of funding for the banking sector by new high-credit quality instrument. It was assumed that such an instrument would bring the following direct benefits[9]:

- obtaining significant additional funds for a new asset class, with potentially lower financing costs for SMEs;
- increasing the volume of SME financing by increasing the net interest margin of banks due to lower costs of funding banking activities;
- expanding the set of liquidity management tools for banks (LCR[10] and NSFR[11]);
- introducing a more effective vehicle for transmitting monetary policy;
- making it easier for regulators and investors to monitor bank balance sheets by implementing uniform and transparent standards of reporting and transparency of SME financing.

Success in implementing a new double-recourse instrument for funding bank lending to SMEs could serve as an example for the development of financing instruments for other sectors of the economy, especially taking into account the needs of energy transformation or implementation of the ESG concept.

2. The concept of a new capital market instrument

In February 2015, the EC submitted for consultation a project to organize a Capital Markets Union, supported, among others, by the ECBC. ECBC, supported the development of long-term investment financing and a single capital market in the EU. Supporting the idea of the Capital Markets Union, ECBC emphasized the key role of the EC in coordinating market and institutional initiatives at the national, European and international levels[12]. The ECBC's position, reflecting a bottom-up

[9] *The role of Dual Recourse Instruments…*, *op.cit.*, p. 8.

[10] Under the rules of the Bank for International Settlements (BIS), banks in the European Union must maintain liquid assets to meet future cash outflows. The EC has defined in detail the assets eligible for this requirement (*Liquidity Coverage Ratio*, LCR). Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council *with regard to liquidity coverage requirement for Credit Institutions*. Text with EEA relevance. OJEU 11/1 dated 17.1.2015.

[11] Due to the failure of many banks to adequately measure, manage and control liquidity risk in 2007 and beyond, the Basel Committee on Banking Supervision (BCBS) introduced two liquidity standards as part of the post-crisis Basel III reforms. The first was the liquidity coverage ratio (LCR). It increases the short-term resilience of banks. The second standard, the Net Stable Funding Ratio (NSFR), aims to promote longer-term resilience by creating incentives for banks to fund their operations from more stable sources. *Net Stable Funding Ratio (NSFR) – Executive Summary*, website of Bank for International Settlement, https://www.bis.org/fsi/fsisummaries/nsfr.htm (accessed: 27.08.2023).

[12] *Analysing the Potential of Dual Recourse Funding Instrument, European Secured Note (ESN), as a Source of Long-Term Financing for the Real Economy in the EU*, European Covered Bond Council, 12.05.2015.

market approach[13], also expressed the market consensus on the development and implementation of a new pan-European instrument for funding bank lending activities through[14]:

- expanding the investor base for SMEs and
- high-quality securitization consistent with the characteristics of sustainable financing.

The ECBC proposal concerned in particular an instrument based on the double recourse mechanism called the European Secured Note (ESN)[15], an instrument that would enable the funding of other classes of assets, compared to traditional mortgage bonds secured by mortgage loans (mortgage covered bonds) or public sector assets (public covered bonds), especially for SMEs and infrastructure projects financed through[16]:

- a double-recourse balance sheet instrument using financing techniques typical of covered bonds;
- an off-balance sheet structure using techniques known from high-quality securitization, with a risk-sharing option for the investor and capital relief for the issuer.

An additional advantage of this new instrument is its countercyclical nature and availability in conditions of market stress. The concept of a new set of ESN-type instruments assumed universal acceptance and similarity of technological solutions in all EU countries, in particular[17]:

- eligibility criteria,
- definitions,
- risk parameters,
- access to data and
- IT solutions.

Moreover, an initiative based on bottom-up market consensus and best market practices could be relatively quickly implemented into national regulations. In turn, clear regulatory and supervisory rules for a high-quality financing instrument would create opportunities for feasibility study on risk and price analysis to be conducted by issuers and investors at the European level.

ECBC proposed the road map for the reconstruction of the European economy, which supports the EC initiative by identifying regulatory constraints. The solu-

[13] *ECBC Response to the Green Paper on Building a Capital Markets Union,* European Mortgage Federation – European Covered Bond Council, Brussels, 12 May 2015, https://hypo.org/app/uploads/sites/2/2021/04/ECBC-Response-to-the-Green-Paper-on-Building-a-Capital-Markets-Union-CMU-2.pdf

[14] *Ibidem*.

[15] *ECBC Response to the Green Paper on Building a Capital Markets Union…*, *op. cit.*, p. 1.

[16] *Ibidem*, p. 2.

[17] *Ibidem.*

tions proposed by the ECBC did not require significant regulatory changes. ECBC concluded that[18]:

- traditional covered bonds ensure the stability of the financial system and access to capital markets in crisis conditions thanks to their clear macroprudential characteristics, and any dilution of these characteristics, by increasing the risk, could violate the systemic importance of this asset class;
- in light of the ongoing discussion on both financing SME and infrastructure projects in the context of high-quality securitization techniques and standards, it is important to establish demarcation criteria separating traditional covered bonds and ESNs due to other types of underlying collateral assets.

In the ECBC's opinion, private sector stakeholders could play a greater role in financing the growth of the real economy if they were given the opportunity to assume risk and price it on a pan-European market platform allowing them to properly analyse the market on a cross-border basis.

An ESN based on the assets of small and medium-sized enterprises, firmly embedded in the national legal, regulatory and supervisory framework, compliant with UCITS[19], could contribute to the implementation of the Capital Markets Union project. The provision of regulatory support for this instrument could be significant and include: eligibility for LCR and repo transactions of the European Central Bank and the Bank of England, lower risk weights in CRR[20] and Solvency II[21], CRA III[22] eligibility and exclusion from bank resolution procedures (bail-in) [23].

This initiative should be supported by the EC and other European institutions performing appropriate functions or tasks in institutional coordination. This may concern the development of uniform guidelines for member countries, the promotion

18 *Ibidem.*

19 Dyrektywa Parlamentu Europejskiego i Rady 2014/91/EU z 23 lipca 2014 r. *w sprawie koordynacji przepisów ustawowych, wykonawczych i administracyjnych odnoszących się do przedsiębiorstw zbiorowego inwestowania w zbywalne papiery wartościowe w zakresie funkcji depozytariusza, polityki wynagrodzeń oraz sankcji*, która zmieniła Dyrektywę 2009/65/EC (*Undertakings for the collective investment in transferable securities, UCITS*). Dz.U.UE L 257/186 z 28.8.2014.

20 Rozporządzenie Parlamentu Europejskiego i Rady (UE) nr 575/2013 z dnia 26 czerwca 2013 r. *w sprawie wymogów ostrożnościowych dla instytucji kredytowych i firm inwestycyjnych, zmieniające rozporządzenie (UE) nr 648/2012* (*Capital Requirements Regulation,* CRR). Dz.U.UE L 176/1 z 27.6.2013.

21 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council *on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)*. Text with EEA relevance. OJEU L 12/1 dated 17.1.2015.

22 Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 *on credit rating agencies*. Text with EEA relevance. OJEU L 146/1 dated 31.5.2013.

23 J. Young, Bail-In: *Definition and Role in a Financial Crisis*, Investopedia, https://www.investopedia.com/terms/b/bailin.asp (accessed: 27.08.2023); *Operational guidance on bail-in implementation*, Single Resolution Board, https://www.srb.europa.eu/en/content/operational-guidance-bail-implementation (accessed: 27.08.2023).

of the roles of national and supranational institutions in investing in ESN or guaranteeing the new instrument, and the promotion of preferential regulatory treatment in the appropriate perspective (for repo transactions or capital requirements), and finally, unification of the definition and categorization of SMEs.

3. Characteristics of ESN demand research

Societe Generale conducted a survey among 16 institutional investors (real money investors), including 75% respondents were asset managers, to examine their attitude towards the ECBC proposals regarding ESN (Costa 2015). Respondents had approximately EUR 5 trillion assets under management. The questionnaire contained 11 questions and aimed to determine what ESN structure they would prefer and what common criteria and features would be necessary to trigger investor demand. The study omitted bank investors because this segment is regulated (at least in terms of LCR eligibility or preferential risk weight), which affects the perception of ESN. It was assumed that large asset managers are more open to new double-recourse instrument. The study also included entities investing in traditional covered bonds.

ESNs, whose purpose is to fund banking activities, position between traditional covered bonds and high-quality securitizations. ECBC proposed two possible ESN structures. The first was a balance sheet instrument (similar to a covered bond), with a dynamic collateral pool and double recourse to the issuer's bank. The second one off-balance sheet and double recourse, also with a dynamic pool of collateral, which can provide capital relief for the issuer and risk participation for the investor.

The market needs a standardized definition of an SME loan or other eligible asset serving as security for the issue to develop ESN. Common quality characteristics and eligibility criteria should be applied equally to all EU countries and it is desirable that ESNs benefit from preferential regulatory treatment. According to Societe Generale analysts, public supervision together with UCITS eligibility will have the key impact on popularizing ESN on the market, especially considering the scope of preferential regulatory treatment in the field of LCR, Solvency II, CRA III and for repo transactions with the ECB and the Bank of England. Moreover, the transparency of ESN data will be important.

Rating agencies also commented on the proposal for the new instrument (Costa 2015, p. 1). Fitch concluded that the credit risk of the balance sheet ESN could be assessed in line with the covered bond rating criteria and the credit risk of the capital relief could be assessed in line with the global structured finance rating criteria. Depending on the type of structural enhancement (increasing collateral) of the new instrument, Fitch could raise ESN's rating by 1-2 notches above the issuer's bank rating, provided that the rating was within the investment grade range. DBRS also stated that it is possible to issue a rating for both types of ESN structures, but the methodology will depend on detailed solutions, including the legal framework, security information, data transparency and whether or not a guarantee is provided.

ESN may be attractive to investors, especially in a situation where the profitability of covered bonds would be relatively low.

Respondents preferred the on-balance sheet structure of ESN over the off-balance sheet structure. They pointed out that cover pools should be homogeneous and easily comparable. For investors preferring off-balance sheet ESNs, an external guarantee would not be necessary, but preferential regulatory treatment would be essential to stimulating demand. In the opinion of respondents, EU legal regulations were preferred to contractual solutions. Other important factors stimulating demand were: liquidity, index inclusion and, to a lesser extent, credit rating. In the context of price, the positioning of the new instrument between covered bonds and other asset classes was indicated as a key demand factor.

4. ESN feasibility study

At the request of the EC, Richard Kemmish Consulting Limited developed a feasibility study for ESN[24], taking into account the supervisory treatment and prudential status of covered bonds as a reference base, and assessed the development potential of this new asset class.

For the purposes of the feasibility study, ESNs were defined as securities using structures developed on the traditional covered bond market to fund assets, in this case loans for SMEs and for infrastructure projects.

The importance of the ESN for the European economy should be seen in the context of the fact that SMEs constitute approximately 99 percent of enterprises in the EU, employ approximately 93 million employees and generate almost EUR 4 trillion of added value[25]. Up to 80 percent their financing comes from the banking system, and only the rest from the capital market (Wehinger 2012). It is also important that SMEs systematically report difficulties in access to financing as one of the most important problems, and their scale varies over time and is not the same for individual countries[26].

The EC Recommendation from 2003[27] defines SMEs as entities employing a maximum of 250 employees with an annual turnover not exceeding EUR 50 million or an annual balance sheet value not exceeding EUR 43 million. Unfortunately, in practice, other definitions are also used (e.g. ECB, national regulations or bank procedures), which constitutes difficulties in the development of ESN.

[24] *Feasibility Study on European Secured Notes*, Richard Kemmish Consulting Limited, European Commission, July 2018.

[25] Eurostat data according to definition of a small and medium-sized enterprise based on annual turnover.

[26] *Survey on the access to finance of enterprises*, website of European Central Bank | Eurosystem, https://www.ecb.europa.eu/stats/ecb_surveys/safe/html/index.en.html (accessed: 27.08.2023).

[27] Zalecenie Komisji z dnia 6 maja 2003 r. *w sprawie definicji mikroprzedsiębiorstw oraz małych i średnich przedsiębiorstw*. Dz.U.UE L 124 z 20.5.2003.

While definitional issues make it difficult to accurately estimate the total exposure of the banking system to SMEs[28], banks covered by the European Banking Authority's transparency survey (representing 85 percent of banking assets in the EU) reported a total exposure of EUR 3 trillion to this asset class[29]. For comparison, this figure for housing mortgage loans, which constitute security for traditional covered bonds, amounted to EUR 7 trillion[30].

Infrastructure bank loans are defined in Solvency II[31] and the Capital Requirements Regulation (CRR)[32]. The exposure of European banks to this asset class is difficult to estimate using the top-down method, among others: due to the cross-border nature of this market, and in particular due to the fact that a significant part of these loans were granted by non-European banks. Bottom-up bank statistics presented in the EBA transparency report showed that these assets amounted to approximately EUR 0.9 trillion[33].

Although there were no bonds based on the ESN concept in the European Union, there were issues of similar financial instruments[34]:

- In 2013, Commerzbank issued a double-recourse instrument secured by loans to SMEs. This issue was structured contractually and as such did not benefit from regulatory supervision, legal protection or preferential prudential treatment that traditional covered bonds receive. However, it was well received by investors and is an interesting casus for ESN.
- Both in Italy and France, national central banks have introduced solutions enabling the use of SME loans as collateral for open market operations. However, these were not highly structured instruments and central banks used relatively high valuation haircuts.
- In Italy, a law (Obbligazioni Bancarie Collateralizzate) was adopted that allows the use of SME loans as security for the issuance of double-recourse bonds, similar to covered bonds, although no implementing regulation has been issued.
- Turkish covered bond regulations allow SME loans to serve as collateral. However, investors' perception of the country's sovereign credit quality suggests that the structure of these bonds is not a good model for ESN.
- SME loans are sometimes used as collateral in securitization transactions. Since the 2007–2009 crisis, a large number of these transactions have been held back by issuers in order to use the assets as collateral for repo transactions, although

[28] Exposures to small and medium-sized enterprises in the banking system are defined in Art. 501 of the Capital Requirements Regulation (CRR), which contains a limit of EUR 1.5 million for a given entity.

[29] *2017 EU-wide transparency exercise*, European Banking Authority, https://www.eba.europa.eu/risk-analysis-and-data/eu-wide-transparency-exercise/2017 (accessed: 27.08.2023).

[30] *ECBC European Covered Bond Fact Book 2017 Edition*, European Mortgage Federation | European Covered Bond Council, Brussels, 25 August 2017.

[31] Commission Delegated Regulation (EU) 2015/35…, *op. cit.*

[32] Rozporządzenie Parlamentu Europejskiego i Rady (UE) 575/2013…, *op. cit.*

[33] *2017 EU-wide transparency exercise…*, *op. cit.*

[34] *Feasibility Study on European Secured Notes…*, *op. cit.*, pp. 32–36.

due to the lower level of disclosure in this market it was not possible to accurately estimate their value. Securitizations, while not dual-recourse instruments per se, are effectively dual-recourse if they are retained by the issuer and used as security.

Traditional overed bonds are subject to special prudential treatment under various EU legal acts and it would be advisable to extend some of them to ESN[35]:

- Derivatives, such as interest rate swaps used to hedge covered bonds, are exempt from clearing under the European Market Infrastructure Regulation (EMIR)[36]. It would be appropriate to ensure the same treatment for derivatives linked to the new instrument, as this would not be contrary to the objectives of this Regulation and would be important for achieving an efficient ESN structure.
- Traditional covered bonds are included in the list of instruments exempt from bail-in under the Bank Recovery and Resolution Directive (BRRD)[37]. Although secured debt is exempt from write-off, it would be necessary to clearly indicate ESN in the list of exempt securities because the related derivative transactions could not benefit from the collateral of the cover pool of underlying assets as in some jurisdictions the bonds themselves are not technically secured but guaranteed by security holder.
- The UCITS Directive allows higher concentration limits for single bonds issuer in the case of eligible covered bonds. This is unlikely to be a problem for ESN in the foreseeable future. However, there is some ambiguity regarding the treatment of other instruments by issuers that also issue covered bonds within this limit. Clarifying this confusion would be helpful for the development of the ESN market.
- Banks investing in covered bonds may assign them a lower risk weight as part of capital requirements. The granting of the same treatment to ESNs is not justified by any empirical data on the risk characteristics of the underlying assets. Moreover, treating ESNs on an equal footing with covered bonds, in accordance with the Capital Requirements Regulation (CRR), would risk undermining the preferential treatment of covered bonds (in recognition of their low risk) and creating a discrepancy between the actual risk and the prudential treatment. The riskier nature of the underlying assets suggests that ESNs should have a higher risk weight than covered bonds, but the benefits of the supervisory process and instrument structure suggest that they should have a lower risk weight than the corresponding unsecured bonds.

[35] *Feasibility Study on European Secured Notes…*, *op. cit.*, pp. 9–10.

[36] Rozporządzenie Parlamentu Europejskiego i Rady (UE) nr 648/2012 z dnia 4 lipca 2012 r. *w sprawie instrumentów pochodnych będących przedmiotem obrotu poza rynkiem regulowanym, kontrahentów centralnych i repozytoriów transakcji*. Tekst mający znaczenie dla EOG. Dz.U.UE L 201/1 z 27.7.2012.

[37] Dyrektywa Parlamentu Europejskiego i Rady 2014/59/UE z dnia 15 maja 2014 r. *ustanawiająca ramy na potrzeby prowadzenia działań naprawczych oraz restrukturyzacji i uporządkowanej likwidacji w odniesieniu do instytucji kredytowych i firm inwestycyjnych* oraz zmieniająca dyrektywę Rady 82/891/EWG i dyrektywy Parlamentu Europejskiego i Rady 2001/24/WE, 2002/47/WE, 2004/25/WE, 2005/56/WE, 2007/36/WE, 2011/35/UE, 2012/30/UE i 2013/36/EU oraz rozporządzenia Parlamentu Europejskiego i Rady (UE) nr 1093/2010 i (UE) nr 648/2012. Tekst mający znaczenie dla EOG. Dz.U.UE L 173/190 z 12.6.2014.

- The liquidity of mortgage bonds was appreciated by treating them as assets included in banks' liquidity coverage ratio (LCR). ESNs are expected to meet the main criteria for inclusion in this indicator, but there will be no empirical data to support this until the market is more established. This is important to support the development of ESNs, which may initially be classified as Tier 2 until the results confirm their eligibility for Tier 1.
- The treatment of covered bonds by investors of the insurance sector depends primarily on the capital allocation rules set out in Solvency II. Based on the premises of the European Insurance and Occupational Pensions Authority (EIOPA) regarding preferential treatment of covered bonds[38], it would be desirable to ensure the same treatment of ESNs secured by loans to small and medium-sized enterprises[39].
- Central banks in Europe accept covered bonds as security with varying degrees of seniority compared to other asset classes. The EC concluded that it is likely that the ECB will grant preferential treatment to ESN. Other central banks were less willing to do so.

The EC expressed the view that the development of ESN will be limited by the procedure for determining the net stable funding ratio (NSFR), although this problem also applies to covered bonds. A more favourable calculation method would be beneficial for the development of the ESN market.

The EBA has published best practices in the regulation, structuring and supervision of the covered bond market[40]. Many of these were subsequently included in the Covered Bonds Directive[41]. Some of the recommendations regarding best practices can be directly applied to ESN, in particular regarding[42]:

- double recourse;
- segregation of the cover pool;
- bankruptcy;
- administration after declaring insolvency;
- derivatives;
- appointing an entity to monitor the cover pool;
- regulatory supervision;
- responsibilities of the competent authority in the event of bankruptcy.

[38] Covered bonds are characterized by lower spread variability due to the granular pool of assets.

[39] Does not apply to ESNs secured by infrastructure loans.

[40] *Opinion of the European Banking Authority on the preferential capital treatment of covered bonds*, European Banking Authority, London, 1 July 2014; *Recommendations of the Harmonisation of the Covered Bond Frameworks in the EU*, European Banking Authority, London, 18 November 2016.

[41] Proposal for a Directive of the European Parliament and of the Council *on the issue of covered bonds and covered bond public supervision* and amending Directive 2009/65/EC and Directive 2014/59/EU. Text with EEA relevance, Brussels, 12.3.2018; 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. Text with EEA relevance. OJEU L 328/29 dated 18.12.2019.

[42] *Feasibility Study on European Secured Notes…*, *op. cit.*, p. 58.

Other best practice recommendations require the following modifications[43]:

- Rules on the composition of the cover pool, which are more difficult to define for ESNs, should remain the responsibility of national supervisory authorities.
- It would not be appropriate or practical to allow non-EEA assets to be included in the cover pool.
- The loan-to-value (LTV) ratio as a measure of credit quality is not appropriate in the case of ESN. There are many alternative measures, of which the EC considered the most appropriate to be the probability of default, which was set at 0.76 percent because it is a similar measure of risk to the 80 percent LTV limit in the current legislation.
- Taking into account the risk associated with the underlying assets in relation to the risk of mortgage residential loans, the EC concluded that the minimum overcollateralization ratio of 12.2 percent for loans to small and medium-sized enterprises and 7.4 percent for infrastructure loans would be appropriate amounts for these asset classes.
- The requirement that the collateral pool maintain liquid assets equal to at least the net outflows under the covered bond program for a further 180 days was considered appropriate, but the differences in ESN issuances from case to case support the calibration of the liquidity measure remain under the responsibility of national supervisory authorities.
- Although supervisory stress tests would be more appropriate for ESNs than for traditional covered bonds, the specific nature of this asset class across jurisdictions (and possibly between different programs within the same jurisdiction) made it appropriate to adapt stress tests, within certain broad parameters, should remain the responsibility of national supervisory authorities.
- The definition of underlying assets would be less harmonized for ESNs than for assets backing traditional covered bonds, so greater emphasis should be placed on disclosure of detailed information about the cover pool. Disclosure of individual assets in the collateral pool would be necessary for ESNs backed by infrastructure loans, but is not necessary for instruments backed by loans to small and medium-sized enterprises. The covered bond market has achieved a very high, harmonized standard of information disclosure through market consensus. The EC assumed that a similar solution would also be achieved on the ESN market. Otherwise, the EBA should consider establishing disclosure standards for ESNs.

Based on face-to-face meetings, an investor survey and a review of publications, the EC concluded that there is significant investor demand for ESNs secured by loans for small and medium-sized enterprises, although there was some skepticism as to whether this asset class will actually develop. There was, however, much greater reticence towards ESNs secured by infrastructure loans, mainly due to their varying credit risk and the complexity of the underlying assets.

[43] *Ibidem*, pp. 58–69.

All investors perceived the adequate fair value of this asset class to be between traditional covered bonds and unsecured debt from the same issuer, and ESNs secured by loans of small and medium-sized enterprises may be more similar in price to covered bonds than to unsecured bonds. The prudential treatment of the ESN, in particular for bank liquidity purposes, and the eligibility of the collateral within the ECB were considered to be the two most important factors in setting the price of the ESN in relation to covered bonds. The supervisory framework was also considered important. As it is more difficult to define a new asset class or standardize the structure across Europe, compared to traditional covered bonds, investors have found greater transparency and reliance on local supervisory processes and a clear, harmonized definition of the new instrument to be equally important elements of ESN valuation.

Investors were divided as to whether investments in ESNs in the initial phase of market development would replace their investments in traditional covered bonds or whether they would replace investments in other asset classes. However, they recognized that as the ESN market develops, they may become an independent asset class.

The EC looked at the national specificity of the ESN concept in 11 member states[44]. In Italy, strong interest in the new asset class has been identified, primarily as a source of collateral for liquidity management purposes and as a replacement for less efficient existing asset-backed financing. In France, there was relatively little appetite for this asset class among major banks, and all preferred traditional covered bond funding. This attitude was confirmed by the relatively low interest in the ESNI (Euro Secured Notes Issuer) instrument of the French central bank (Banque de France). Only one of the banks, without a significant position on the mortgage loan market, expressed great interest in the new asset class. None of the consulted Swedish stakeholders were interested in ESN. They all expressed the belief that traditional covered bonds would be a more advantageous and sufficient source of funding banking activities. In Germany, the dominance of the covered bond market (Pfandbrief) and the traditionally high level of liquidity, especially in savings banks, indicated little potential for the development of ESNs secured by loans of small and medium-sized enterprises. In turn, ESNs secured by infrastructure loans were found to have potential that is not widely recognized in other member states. Although the new asset class would pose some structuring challenges, a model of preferential prudential treatment was not considered necessary to enhance the financing structure. Spanish market participants emphasized the significant and growing surplus of financing opportunities in the traditional covered bond market and the lower credit quality of loans to small and medium-sized enterprises, which made traditional covered bonds their preferred funding instrument for the foreseeable future. In Denmark, little need for a new financing instrument was identified and some stakeholders expressed concern that ESNs could undermine the traditional covered bond market. It was considered unlikely that the Central Bank of Denmark

[44] *Ibidem*, pp. 81–88.

would accept ESN denominated in Danish krone as collateral. Irish banks limited the use of secured financing due to large deposit balances and the need to issue senior debt for bank resolution purposes (bail-in). At the same time, it was recognized that during the financial crisis, ESNs could serve as a useful tool for generating liquidity from bank balance sheet items, although interest in this instrument was relatively low. In Poland, there were divergent opinions on the potential of ESN. Some issuers argued that due to the structural surplus of deposits over loans, there would be little or no need for secured financing, while others stated that ESNs could be a way for smaller banks to overcome the market entry barriers resulting from the Polish model of specialist mortgage banking. Romanian banks did not use the possibility of funding using covered bonds due to the excess liquidity in the banking system. They expressed some skepticism about the credit quality of the underlying assets. Furthermore, the European Investment Bank (EIB) loan available at that time was deemed to have more than met the financing needs of the SME sector at that time. In Slovakia, banks were previously obliged to issue specific amounts of covered bonds. When this restriction is lifted, banks expected a significant reduction in secured funding. Loans to small and medium-sized enterprises there constituted a relatively small part of total banking assets. Estonia did not have legal framework regarding covered bonds. None of the stakeholders saw any significant disadvantages of the ESN concept, but in the foreseeable future it was expected that the main effort would be devoted to developing regulations on financing using traditional covered bonds.

It should be assumed that there will be significant differences in the upfront and ongoing costs of ESNs in different countries and for different issuers, in particular due to differences in the scale of necessary changes to banks' IT systems that will be needed to handle transactions based on loans for small and medium-sized enterprises. This would not necessarily be the case for infrastructure ESNs, given the nature of the underlying assets. Other upfront costs were expected to be similar to those of traditional covered bond transactions, although slightly higher.

The rate of return expected by investors depends largely on the overall rate of return in the market for various instruments at a given time. Taking into account long-term averages for covered bonds and senior unsecured bonds issued by banks of 37 basis points and 93 basis points above mid-swaps, respectively, it was estimated that the ESN would require a yield of 45 to 50 basis points above mid-swaps. This would represent an additional cost compared to traditional covered bonds of 8 to 13 basis points, while saving compared to unsecured financing of 43 to 48 basis points[45]. The credit enhancement required by rating agencies was estimated to be 23 percent[46], although it may vary significantly from case to case. The obtained estimated values depend on many decisions that have not yet been made and on arbitrary decisions of the EC. Therefore, they should be treated as maximum yields that are possible to achieve for the base scenario of the adopted assumptions.

[45] *Ibidem*, pp. 92 and 94.
[46] *Ibidem*, p. 96.

Assuming that the ESN market ultimately finances the same proportion of eligible underlying assets as the traditional covered bond market in each country, the potential market size would be EUR 1139 billion for SME ESNs and EUR 195 billion for infrastructure ESNs[47]. However, given the lower effectiveness of collateral and the higher cost of financing for ESNs compared to covered bonds, it is unlikely that these levels will be achieved.

As a result of the research, the following scenarios were identified in which ESN emissions may occur[48]:

- Funding of banks in the event of a significant deterioration in the economic situation on the mortgage loan market, which reduces the possibility of issuing traditional covered bonds. In an extreme downturn scenario (a two standard deviation decline in the value of mortgage loans over five years), 11 banks were identified that could use the ESN to cover a business funding shortfall of EUR 104 billion. Taking into account the decline in available mortgage assets by another 10 percent, the number of banks would increase to 16 and the volume of ESN issuance to EUR 121 billion.
- Under normal market conditions, obtaining financing by banks that do not have assets that could secure a traditional covered bond program, but have assets that could constitute security for the ESN program. There were 7 banks meeting this criterion in the transparency survey, which would represent a potential issuance size of EUR 86 billion.
- Circumstances in which the assumption that ESNs are more expensive or less effective in terms of security than traditional covered bonds does not prevail, for example where there are particular problems with national covered bond regulations or the mortgage loan market, for example in Poland or elsewhere in the future.

In the last two cases, it is difficult to estimate the potential volumes of ESN programmes.

The potential benefits of ESN legislation include[49]:

- Increasing the availability of funding and/or reducing the cost of funding the underlying assets. This would be the case for a small number of specialist lenders, as institutions with assets eligible for the issuance of covered bonds would primarily use traditional programs.
- Increasing the availability of funding and/or reducing funding costs in growth scenarios where traditional sources of funding may prove insufficient. Assuming 1 percent mismatch between loan growth and deposit growth over a five-year period, 10 banks in the EBA transparency survey would lack the issuance capacity under traditional covered bond programs, which could lead to the issuance of ESNs worth up to EUR 18 billion. Increasing the financing gap to 10 percent

[47] *Ibidem*, p. 100.
[48] *Ibidem*, pp. 103 and 105.
[49] *Ibidem*, pp. 14–15.

would result in an increase in the number of banks to 19 and the volume of ESN issuance to EUR 34 billion.
- Increased financial stability. The extent to which ESNs could remedy 5 percent annual funding shortfall over a 5-year period indicates the extent to which ESNs can be used in emergency liquidity situations.
- Increase in investments. Based on the average level of investment, it was estimated that 15 percent of ESN investors would come from outside the EU as these assets would be relatively more attractive to them.
- Benefits for investors in the EU. ESNs would enable risk diversification in traditional covered bond portfolios resulting from excessive prices of residential properties in some member states.

Legislative actions towards ESN were considered justified because, assuming that the market would develop anyway in the absence of dedicated regulations, a more desirable scenario would be the introduction of legislative solutions that would ensure that this would happen in a harmonized manner.

The costs of ESN’s legislative activities include[50]:

- Potentially negative impact on the existing traditional covered bond market. This phenomenon can be divided into damage that would occur as a result of contagion if the ESN program became insolvent, and more theoretically, which is difficult to estimate, damage if no insolvency occurred but there was competition for investors. The range of potential insolvency costs was estimated at EUR 100 to 400 million.
- An increase in the encumbrance of the bank's assets, although this was not considered a significant risk as the impact on the LGD (loss given default) of unsecured lenders is minimal in the case of the likely volumes of ESN issuance.

5. SWOT analysis of ESN

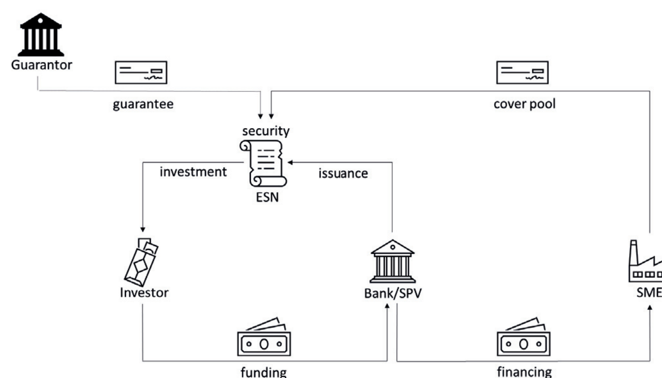
The financial mechanism of ESN is similar to the financial mechanism of covered bonds. The issuer of ESN is therefore either directly a bank providing financing to small and medium-sized enterprises or its special purpose vehicle, depending on the mortgage banking model of a given domestic market. The basic security for the issue of instruments purchased by investors are receivables from loans granted – as in the case of covered bonds, and additionally possible guarantees from public entities – which distinguishes ESN from covered bonds. Funding banking activities using ESN is of a targeted nature, which means that the funds from the programme are used to finance lending to small and medium-sized enterprises.

ESN is a new instrument for funding banking activities, ensuring stable, long-term financing, even in situations of market stress. At the same time, it increases the bank’s liquidity management capabilities. The advantage of ESN is that its structure is based on the best market practices of covered bonds, while its weakness is its

[50] *Ibidem*, p. 15.

structurally lower credit quality, resulting from the higher risk profile of loans for small and medium-sized enterprises compared to mortgage loans, which are the underlying assets for the issue of covered bonds. The higher risk of loans for small and medium-sized enterprises also results from the fact that they are usually unsecured, while residential loans are secured by a mortgage. Obtaining adequate investor interest in a new instrument may therefore require either obtaining additional security, in the form of a guarantee from a public entity, or ensuring an appropriately higher profitability. Mortgage loans and covered bonds are long-term instruments, while loans for small and medium-sized enterprises have shorter maturities, which means that the assets securing the issue of the new instrument will be subject to greater rotation. ESN has no credit history yet, while the covered bond has been present on the capital market for over 250 years and enjoys an impeccable credit history (no case of default has been recorded so far). The disadvantage of the new instrument, as in the case of covered bonds, is the increase of assets encumbrance, which reduces the available pool of assets subject to redemption in the event of restructuring or liquidation of the bank.

Figure 1. ESN financing model



Source: Own study

An opportunity for the development of the ESN market is the significant demand and, at the same time, a persistent shortage of financing for small and medium-sized enterprises, especially since ESNs should contribute to reducing the cost of financing for small and medium-sized enterprises. From an investor's point of view, ESN is an opportunity to achieve higher profitability and expand diversification. The new instrument should help to increase the level of investment by stimulating the inflow of capital from outside the EU. An element building the supply of new instruments would be providing ESN with regulatory preferences known from the covered bond market (e.g. capital relief for bank issuers or eligibility for repo transactions with the ECB). ESN expands the range of monetary policy instruments of

central banks by analogy to the covered bond purchase program. Increasing the possibilities of stable, long-term funding of banking activities, also in crisis situations, contributes to increasing stability not only at the level of individual banks but also at the level of the entire financial system. The EC's high priority for supporting small and medium-sized enterprises and the development of investments and the capital market is also a stimulus for the development of the ESN market. Due to the different risk profile, it is important that the new instrument is properly separated from covered bonds so that its introduction does not negatively impact the covered bonds market. A threat to the success of the new instrument was the need to issue redemption instruments (MREL type), which displaced potential ESN issues. The freeze of global markets as a result of the Covid-19 pandemic, was not conducive to the development of new instruments. The widespread lockdown and disruption of supply chains, which led to the global crisis, forced the implementation of stimulus programs that floated the market with cheap funding, as a result of which the markets are now facing unprecedented high inflation, which was compounded by the outbreak of the war in Ukraine, and recently additionally in the Middle East, leading to an increase in overall investment risk.

ESN is an interesting proposal of a new, countercyclical, capital market instrument that can replace the expiring anti-crisis, pro-inflation government aid programs.

Table 1. ESN SWOT

Strengths	Weaknesses
• Expanding the range of funding and liquidity management instruments for banks. • Based on best market practices. • A countercyclical market tool that can replace government anti-crisis aid programs.	• Structuraly lower credit quality. • Typically no collateral and short maturity of the underlying assets. • No credit history of the new instrument. • Increased encumbrance of bank assets.
Opportunities	**Threats**
• The need for financing and the possibility of reducing the costs of financing for SMEs. • Investor demand for instruments with higher profitability, increased diversification and investment level. • Possible regulatory preferences. • Expanding the range of monetary policy instruments. • Positive impact on the stability of the financial system. • EC support resulting from the goals of the Capital Markets Union.	• Potentially negative impact on the covered bond market. • Necessity to issue redemption instruments. • Increased market risk.

Source: Own study.

Summary

The search for new solutions supporting the financial sector on the one hand and facilitating financing the real economy on the other led to the formulation of the concept of the Capital Markets Union and within it a new capital market instrument. The article characterizes selected aspects of the construction of the ESN market, which is used in particular to finance small and medium-sized enterprises by banks.

The concept of a new double-recourse capital market instrument for stable, long-term funding of bank lending to SMEs is high on the EU's priorities. Modeled on solutions that contributed to the popularity of covered bonds, ESNs address the financial needs of a key segment of the European economy, particularly affected by the COVID-19 pandemic. At the same time, they meet the needs of investors looking for profitable, low-risk instruments. By ensuring the transparency and standardization of ESG data for SMEs, ESNs can support the development of a post-pandemic and sustainable European economy, especially after the end of government support programs and quantitative easing by central banks. The development of ESN would be supported by the preferential regulatory treatment known from covered bonds, as well as the capital relief for banks based on the securitization mechanism by lowering prudential requirements. The analysis carried out across the main stakeholders: issuers, investors, the real economy sector as well as market supervision and political decision-makers, leads to the conclusion that the ESN market, despite the lack of enthusiasm among some market players, has significant potential and its construction has a well-founded business justification, supported politically and normatively by EU agencies.

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