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COVER NOTE

From:	European Economic and Social Committee
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To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
Subject:	Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on sovereign bond-backed securities *- Opinion of the European Economic and Social Committee*

Delegations will find attached the above mentioned opinion.

Encl.: […]

European Economic and Social Committee

ECO/471

EU sovereign bond-backed securities (SBBS)

OPINION

European Economic and Social Committee

Proposal for a Regulation of the European Parliament and of the Council on sovereign bond-backed securities

[COM(2018) 339 final – 2018/0171 (COD)]

Rapporteur: **Daniel MAREELS**

Consultation	European Parliament, 05/07/2018 Council of the European Union, 06/07/2018
Legal basis	Articles 114 and 304 of the Treaty on the Functioning of the European Union
Section responsible	Section for Economic and Monetary Union and Economic and Social Cohesion
Adopted in section	03/10/2018
Adopted at plenary	17/10/2018
Plenary session No	538
Outcome of vote (for/against/abstentions)	201/3/8

1. **Conclusions and recommendations**

1.1 The EESC welcomes these proposals on SBBSs, which fit into the broader context of completing the Banking Union and building a Capital Markets Union (CMU). The Committee has in the past been a strong supporter of and advocate for both of these unions. Moreover, the proposals also have the potential to make a positive contribution to financial stability and resilience.

1.2 Conceptually speaking, the SBBSs aim to tackle the traditionally close link between banks and their home countries ("sovereigns"). Since the financial crisis, the EESC has been calling for something to be done about this, strongly advocating a weakening of this link. Notwithstanding the efforts that have already been made in this connection, the EESC therefore welcomes the fact that action is being taken through the current proposals.

1.3 Indeed, SBBSs can lead to a situation where banks are able to reduce their exposure to the public debt of their home country and better diversify their portfolios of sovereign debt. In addition, the new instrument does not involve sharing risks and losses between euro area Member States. If need be, these would be fully borne by the SBBSs' investors.

1.4 Currently, SBBSs would be identified as "securitisations" for the purposes of applying the regulations, actually making them unattractive for banks to invest in. The Committee deems it entirely appropriate for this situation to be rectified. The alignment of SBBSs with national euro-denominated sovereign bonds from the euro area (sovereign exposures) will have to allow investors from the financial sector to invest in SBBSs under the same conditions as they do now in the underlying sovereign bonds from the euro area.

1.5 These proposals simply constitute an enabling framework that allows the development of SBBSs by the market. For the Committee, it is of great importance to ensure the clarity, efficacy and effectiveness of this framework under all circumstances. Moreover, there should be no negative or detrimental impact.

1.6 In respect of the proposed regulatory framework, the EESC's stance is somewhat qualified. It agrees with a number of aspects such as the principle of SBBSs being issued by a Special Purpose Entity (SPE). Other aspects, such as self-certification of the composition of the underlying portfolios by SPEs, need to be strengthened. In view of the importance thereof, tighter and even prior monitoring by the European Securities and Markets Authority (ESMA) would seem appropriate.

1.7 A number of questions also remain unanswered. Thus, the question arises as to whether SBBSs will work effectively in all circumstances. Moreover, how will they fare in times of general crisis, or of crisis in one or more Member States? What are the consequences of dividing issues into tranches, when it seems that the senior tranches (which entail less risk) can only be placed on the market if enough investors are found for the junior tranches (which entail greater risk)? Issues thus appear to assume a risky, precarious aspect, and this shortcoming at the very least undermines the potential success of SBBSs.

1.8 Likewise, it is very important to take a positive approach to the "markets" and other key stakeholders in respect of SBBSs. They need to agree to put efforts into making this instrument a reality. The markets and Member State representatives were rather critical during the preparatory stakeholder consultations. The Committee considers it indispensable to undertake dialogue and consultation with all stakeholders in order to jointly develop constructive solutions.

1.9 In overall terms and taking all the above-mentioned points into consideration, the EESC feels that the only way to find out a) whether banks will switch from bonds from their home countries to SBBSs for their investments and b) whether investors will be prepared to buy "junior" tranches in sufficient quantities to justify the creation of SBBSs, is to test this new financial instrument - the SBBS - on the market.

1.10 Lastly, the Committee feels that further thought also ought to be given to the matter of whether SBBSs can be acquired by private savers and consumers. Taking into account the fact that, on the one hand, this is a particularly complex product and, on the other, it is divided into tranches, the Committee is inclined to think that acquisition should only be considered for "senior" tranches, but not for "junior" tranches. Only the former present limited risks and are comparable with direct ownership of sovereign bonds by the same savers and consumers.

2. Background

2.1 On 24 May 2018 the Commission published its proposal[1] for a market demand-led development of sovereign bond-backed securities (SBBSs).

2.2 This proposal fits into the broader context of completing the Banking Union and building a Capital Markets Union (CMU). It focuses in particular on further weakening the link between banks and their national governments ("sovereigns"), and therefore emphasises risk reduction and private-sector risk sharing. Its cross-border nature means that it is also intended to contribute to further integration and diversification of financial markets for government securities in the internal market.

2.3 In the past, banks tended to have extensive holdings of sovereign bonds from their own national governments (home countries), which, it emerged during the financial crisis, may present certain risks. There have therefore since been calls for that link to be weakened.

2.4 In response, the SBBS has been proposed, the aim of which is to allow banks to improve the geographic distribution of their sovereign bond portfolios. This also takes account both of the lower supply of these bonds and of financial institutions' demand for such assets, including because of new regulatory requirements to hold sufficient buffers of highly liquid assets.

2.5 SBBSs are a novel financial instrument, and the current proposal aims to remove the barriers that have so far impeded their development. In concrete terms, the proposed enabling framework essentially has two objectives:

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[1] COM(2018) 339 final

2.5.1 establishing a tailored overall framework for SBBSs, which would "standardise" this new instrument and should thus also benefit its liquidity;

2.5.2 in this connection, removing regulatory barriers to the use and acquisition of SBBSs. In essence, this involves applying a kind of "look-through" approach for investors in this type of SBBS, which means that the same regulatory rules will apply as if they held the underlying sovereign bonds themselves.

2.6 One specific feature – and key characteristic – of SBBSs concerns their underlying portfolio. In order to achieve the aforementioned geographic risk diversification within the Banking Union and the internal market, it should be exclusively composed of sovereign bonds of all euro area Member States. A further restriction is that only issues denominated in euro should be eligible. They will be included in SBBSs in proportion to the economic weight of the respective Member State.

2.7 Another very specific element is the fact that it is the investors who bear the risks and losses. SBBSs will be composed of tranches, and investors may choose between lower-risk senior tranches and higher-risk junior tranches. Moreover, the underlying portfolios provide their only guarantee, as the proposal requires issuers of SBBSs to be special purpose entities that must not undertake any other activities and against which no claim is possible[2].

2.8 Also with regard to investors, a kind of "look-through" approach will, as mentioned above, be applied for the regulatory treatment of SBBSs. This means no longer looking at the legal "packaging" of the instrument as "securitisation"[3], but instead at the underlying government securities contained in the SBBS. Where appropriate, investors will get the same regulatory treatment for SBBSs that meet all the conditions as for government securities they own directly, in terms of capital requirements, concentration limits, and liquidity limits.

2.9 The present proposals create the terms and conditions for SBBSs and establish their prudential treatment, but it will ultimately be up to the "market" to make use of them. Issuers and investors will ultimately decide whether this new financial instrument becomes a reality and, if so, how and to what extent it will be used.

3. Comments

3.1 The Committee welcomes this proposal on SBBSs, which fits into the broader context of completing the Banking Union and building a Capital Markets Union (CMU). The Committee has in the past been a strong supporter of and advocate for both of these unions[4].

3.2 More specifically, these proposals aim to further weaken the link between banks and their home countries. Ever since the financial crisis, the Committee has strongly advocated weakening this link, and it is therefore pleased that the proposal addresses this, taking into account the context of simultaneously declining supply of and increasing demand for sovereign bonds.

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2 Apart from in exceptional cases such as abuse of the designation "SBBS".

3 In that case, the regulatory requirements would be stricter.

4 OJ C 81, 2.3.2018, p. 117, OJ C 237, 6.7.2018, p. 46 and OJ C 177, 18.5.2016, p. 21.

3.3 SBBSs, as a new financial instrument, have the potential to improve and broaden diversification in the exposure of banks and other financial institutions to sovereign bonds ("sovereign bond holdings"). This will undoubtedly help to reduce risks in the financial sector.

3.4 The proposal is simply an enabling framework that allows the development of SBBS by the market, without itself going quite so far. When actual development is taken up by the market, this will lead to the creation of a new financial instrument and a market for the same. The Commission estimates the impact thereof in two scenarios[5]. If only a limited volume of SBBSs are created, then the impact is estimated at around EUR 100 billion; if a broader approach is adopted, with an estimated impact of EUR 1 500 billion, then this will have a macro-economic impact.

3.5 Wide dissemination of SBBSs also has the potential to improve financial market integration, and would thus help to improve financial stability and the resilience of the financial system.

3.6 In the Committee's view, it is important for the proposed enabling framework to be clear, functional and effective in all circumstances, and to have no negative or adverse effects. In addition, and in order to increase the chances of success, it is very important to take a positive approach to the "markets" and other key stakeholders – they need to agree to put the work into making SBBSs a reality.

3.7 The markets and Member State representatives were rather critical during the preparatory stakeholder consultations. For example, market participants had mixed views on the viability of SBBSs. "Debt Management Officers", in turn, took the view that SBBSs would neither break the bank-sovereign nexus nor create a low-risk asset. And representatives of the Member States have recently signalled that, in their view, the need for SBBSs is not immediately obvious[6]. The Committee considers it indispensable to undertake dialogue and consultation with all stakeholders in order to jointly develop constructive solutions.

3.8 Without prejudice to comments made above and below, the proposed regulatory framework for SBBSs can count on the Committee's support in general, particularly as it stops the current penalisation of similar instruments and at the same time takes a "benchmarking" approach.

3.9 The Committee also supports, among other things, the fact that SBBSs would be created and issued by private sector entities. It seems right that the issuer should be a special purpose entity (SPE) that does not undertake any other activities, as this makes things clearer for everyone.

3.10 The mandatory inclusion of euro-denominated sovereign bonds from all euro area Member States, in proportion to their economic weight[7], achieves the distribution and diversification referred to in point 3.3. In addition, the inclusion of certain sovereign bonds makes them more attractive to international investors. This applies in particular to sovereign bonds from certain countries that are otherwise issued in smaller and less liquid markets.

5 SWD(2018) 252 final, p. 70

6 For more detail on these concerns and comments, see point 3 of the explanatory memorandum to the draft regulation (p. 6).

7 See Article 4(2) of the proposal for a regulation and, for figures concerning the economic weight of the Member States concerned, https://www.ecb.europa.eu/ecb/orga/capital/html/index.en.html

3.11 In view of the importance of the above-mentioned mandatory inclusion of sovereign bonds from all Member States in proportion to their economic weight, the Committee would query the current system of self-certification by issuing bodies. The question arises as to whether there should not be stricter and prior monitoring by ESMA.

3.12 It is also important that the new instrument does not involve sharing risks and losses between euro area Member States: the risks and losses are fully borne by investors in SBBSs.

3.13 As the issuing institution, the SPE issues a series of securities representing claims on the proceeds from the underlying portfolio. These securities bear different risks, with "senior tranches"[8] bearing the lowest risk and "junior tranches" the highest. It seems that, in practice, the senior tranches can only be placed on the market if enough investors are found for the junior tranches[9]. This makes any issuance arbitrary and precarious, and is a weakness that undermines the potential success of SBBSs.

3.14 Moreover, the question also arises of whether SBBSs will work effectively in all circumstances. How will they fare in times of general crisis, or of crisis in one or more Member States? This is an important question, given that recent events have once again shown that the financial markets react quickly to situations like this.

3.15 It is also important to clarify what the impact will be of creating an SBBS market alongside the existing market for individual Member States' sovereign bonds. Several questions arise in this regard: for example, will sufficient volumes be available in all circumstances? And what if they are not? Will creating an additional market not lead to fragmentation?

3.16 The regulatory framework also allows savers and consumers to acquire and hold SBBSs[10]. Given that these are especially complex products, one might be tempted not to allow this, but perhaps a more nuanced approach is necessary, whereby they should only be banned from acquiring "junior tranches", precisely because they may also involve major risks. It could be different for "senior tranches", which present a low risk and certainly bear comparison with direct holdings of sovereign bonds by the same savers and consumers. The Committee calls for more thought to be given to this matter.

3.17 Finally, the Committee considers it entirely correct that, for the purposes of applying the regulation, SBBS are treated as equivalent to euro-denominated national sovereign bonds from the euro area (sovereign exposures). This should allow investors from the financial sector to invest in SBBSs under the same conditions as for the underlying euro area sovereign bonds.

3.18 On the whole, taking account of all the above comments, the Committee thinks that in conceptual terms the idea of SBBSs is an attractive one, but that the way it is developed in the proposals presents a more mixed picture and raises a number of issues. In addition, the critical comments and responses from market players and other key stakeholders should not go unanswered. However, generally speaking the Committee agrees with the Commission that a "proper" answer can only be found in practice by testing the concept in the "real" markets.

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8 Senior tranches would be the largest part of the issues, and junior tranches the smallest part.

9 Junior tranches normally get a higher return for this higher risk.

10 See Article 3(6) of the draft regulation.

Brussels, 17 October 2018

Luca JAHIER,

The president of the European Economic and Social Committee