European Commission

INCEPTION IMPACT ASSESSMENT

Inception Impact Assessments aim to inform citizens and stakeholders about the Commission's plans in order to allow them to provide feedback on the intended initiative and to participate effectively in future consultation activities. Citizens and stakeholders are in particular invited to provide views on the Commission's understanding of the problem and possible solutions and to share any relevant information that they may have, including on possible impacts of the different options.

TITLE OF THE INITIATIVE	Enabling regulatory framework for the development of sovereign bond-backed securities
LEAD DG – RESPONSIBLE UNIT	DG FISMA-E1
LIKELY TYPE OF INITIATIVE	Proposal for a regulation
INDICATIVE PLANNING	Q2 2018
ADDITIONAL INFORMATION	https://ec.europa.eu/commission/priorities/deeper-and-fairer-economic-and-monetary-union_en https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union_en https://ec.europa.eu/commission/sites/beta-political/files/letter-of-intent-2017_en.pdf

The Inception Impact Assessment is provided for information purposes only. It does not prejudge the final decision of the Commission on whether this initiative will be pursued or on its final content. All elements of the initiative described by the Inception Impact Assessment, including its timing, are subject to change.

A. Context, problem definition and subsidiarity check

Context

Sovereign Bond-Backed Securities (SBBS) are a novel financial instrument and consists of securitisation tranches issued against a portfolio of euro-area central government bonds. Initially proposed in a European Systemic Risk Board (ESRB) working paper (#21/2016), the Commission put forward SBBS at several occasions as a possible measure to advance the completion of the Banking Union and the deepening of Economic and Monetary Union. In particular, SBBS could facilitate diversification of banks' sovereign exposures and thus further weaken the bank-sovereign nexus, which proved a key vulnerability in the euro area debt crisis, and expand the supply of low-risk euro-denominated assets. President Juncker's 2017 Letter of Intent in the context of the 2017 State of the Union address, the May 2017 Reflection Paper on deepening economic and monetary union, the October 2017 Banking Union Communication as well as the December 2017 package on Economic and Monetary Union deepening[1] underscore the potential of SBBS and commit the Commission to launch by 2018 "an enabling framework for the development of SBBS to support further portfolio diversification in the banking sector".

The Commission initiative builds on the work of an ESRB High-Level Task Force established in 2016 to assess SBBS' feasibility and merits. The task force delivered its final assessment to the ESRB General Board on 7 December 2017. A full report is expected to be published.

Problem the initiative aims to tackle

While SBBSs could help advance the Banking Union and deepen and strengthen EMU — two key priorities for the Commission — the current regulatory framework discourages the issuance of such instruments by failing to adequately reflect their characteristics,[2] whereas it needs to be facilitated and encouraged: Under current rules, SBBS would be treated as securitisation products, and hence significantly less favourably, along several dimensions (such as capital requirements, eligibility for liquidity coverage and collateral, etc.), than their underlying portfolio of euro area sovereign bonds.

Yet, SBBS would not carry any of the risky features (i.e. opaqueness of the underlying assets and absence of market-determined prices to value them) that justify capital surcharges and/or liquidity discounts for traditional

[1] See https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf, http://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf and https://ec.europa.eu/commission/publications/completing-europes-economic-and-monetary-union-factsheets_en.

[2] A similar problem has been addressed with the regulation laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised (STS) securitisation (Regulation (EU) 2017/2402). Specifically, treating STS and non-STS securitisations equally failed to account for the former's lower risk and thus discouraged the issuance of STS securitisations. In effect, the STS regulation has established the principle that securitisations with "high quality" underlying assets warrant a "better" regulatory treatment than normal securitisations. The proposed legislative initiative would apply this same principle to the novel SBBS asset class.

securitisations. In particular, the underlying assets of SBBS (i.e. central government bonds of euro-area Member States) would be transparent, liquid and tradable securities themselves. Furthermore, the composition of the underlying portfolio would be known and pre-determined (e.g., in line with the ECB capital key).

This has two direct consequences. First, SBBSs would not pose the risk of "adverse selection" of traditional securitisations (whereby it needs to be prevented that the originator may be packaging assets of inferior quality, which justifies risk retention rules). Second, SBBSs are perfectly replicable by purchasing the underlying sovereign bonds. Thus the regulatory surcharges and liquidity discounts that apply to traditional securitisations are not warranted and should not be borne by the product.

Since under the current regulatory framework SBBS carry higher regulatory charges and larger liquidity discounts than its underlying portfolio of government bonds, an investor would always prefer (and be able to) buy the underlying portfolio, rather than SBBS. Thus, the unequal regulatory treatment of SBBSs relative to that of the underlying portfolio of euro area government bonds prevents the issuance of SBBS.

Basis for EU intervention (legal basis and subsidiarity check)

The legislative provisions governing the regulatory treatment of securitisation are EU regulations (e.g. the Capital Requirements Regulation, or CRR, which is based on Article 114 TFEU). Individual action by Member States would not be able to achieve the goals of this legislative initiative, i.e. remove regulatory impediments, since the amendments of EU legislation can only be done through EU action. Aside from this legal consideration, even if such instrument was subject to national legislations, intervention at Member States' level would be suboptimal: different instruments would be "enabled" in different manners, which would make it difficult (or even impossible) for any of them to reach sufficient size and liquidity, and an inefficient race to offer a regulatory treatment as favourable as possible could emerge. Moreover, different national legislations would create de facto obstacles to the Single Market (e.g., high compliance costs for an arranger that would want to operate in multiple jurisdictions).

B. Objectives and policy options

The legislative proposal aims at removing unjustified regulatory impediments to the development of SBBS by the private sector.

Levelling the regulatory playing field between SBBS and their underlying bonds would require adapting the regulatory framework for securitisation to better reflect SBBS' defining and distinguishing features.

The legislative proposal would need to:

1. Introduce the legal definition of SBBS, including a list of features required for any (privately-produced) securitisation of euro area national government bonds to qualify as SBBS. The requirements in this list can in principle be general (e.g., "a representative portfolio composition") or very specific (e.g., actual portfolio weights are spelled out) or somewhere in between.
2. Ensure that regulation treats investments in SBBS and in government bonds in a consistent manner.

The main choices that will need to be made include:

- The scope of applicability of the legislation (e.g., all securitisations of euro-area sovereign bonds or only those issued against a portfolio in line with the ECB capital key, as recommended by the ESRB work)
- The extent to which the benchmark regulatory treatment for sovereign bonds should be granted to the various tranches (i.e., only to the senior tranche or to all tranches); and
- How to ensure that a given product complies with the requirements to be eligible for such treatment.

C. Preliminary assessment of expected impacts

Likely economic impacts

The levelling of the regulatory playing field would facilitate and encourage the development of an SBBS market. This in turn would be expected to help achieve the goals mentioned above (i.e., greater diversification of banks' sovereign exposures; weakening of spill-overs from sovereigns to banks; creation of a new euro-denominated low-risk asset based on government bonds of all euro area Member States, etc.). Financial stability would thereby be enhanced and the risks and impact of banking crises reduced. This could support investment and growth. These effects could be expected to be larger for those Member States at present most exposed to risks from adverse sovereign-bank spill-overs.

All Member States would indirectly contribute to this synthetic low-risk asset and thus could be expected to share in the associated benefits (e.g., in terms of lower borrowing costs). At present, the benefits of issuing "low-risk assets" accrue only to a select subgroup of Member States.

The impact of SBBS on the underlying euro-area sovereign bond markets, e.g. in terms of their liquidity, would depend on the pace at which the SBBS market develops and the size it reaches. Preliminary analysis suggests that potential adverse effects on sovereign bond market liquidity would be limited, especially if the SBBS market develops only gradually. On the other hand, through SBBS, even small Member States and other Member States that at present, for reasons for example of limited debt issuance, do not manage to appeal to global investors might indirectly benefit if SBBS become an attractive investment product.

Neither the proposed legislative initiative, nor the SBBS market—to the extent it develops—are expected to impact directly on retail investors, households or SMEs, because they would unlikely be active in SBBS markets. At the same time, these sectors would benefit indirectly—including from enhanced confidence—to the extent that the above-mentioned macroeconomic and financial-stability benefits materialise.

Likely social impacts

No direct social impact is expected. Indirect effects from the mentioned macroeconomic gains are possible, but hard to estimate.

Likely environmental impacts

No environmental impact is expected.

Likely impacts on fundamental rights

No impact on fundamental rights is expected

Likely impacts on simplification and/or administrative burden

Issuers of SBBS may need to obtain a license, or each SBBS issuance would need to be certified as SBBS-compliant in order to qualify for the envisaged regulatory treatment. The mechanism of licensing and certification could involve a self-attestation or public entity involvement. Hence the process would involve some administrative burden and costs at the level of potential issuers (be they private or public) and the institution that would certify/supervise compliance. For the product to be viable, these costs would have to be kept at a minimum.

D. Evidence base, data collection and better regulation instruments

Impact assessment

An impact assessment will be conducted to provide:

1. An indicative quantification of the regulatory hindrance faced by SBBS under the status quo;
2. An indicative quantification of the benefits from the development of an SBBS market in terms of diversification of banks' balance sheets, de-risking, and expansion of the supply of euro-denominated low-risk assets.

Evidence base and data collection

Evidence of the problem as defined here (disincentives to issuance or use of SBBS) can be gathered by comparing the treatment of securitisation tranches under the applicable regulations with that of sovereign government bonds.

A quantification of the material effect of the current unjustified regulatory treatment (more precisely, a sense of the order of magnitude of the burden) can be offered making assumptions as to the extent to which banks would switch their sovereign portfolios into (various tranches of) SBBS.

Consultation of citizens and stakeholders

No further public consultation will be conducted, as extensive public and stakeholder consultation has already been undertaken in the course of the ESRB High Level Task Force work on SBBS. In particular:

- A dedicated industry workshop was held in Paris in November 2016,
- A public survey/questionnaire was run on the ESRB website at the end of 2016.[3]
- A workshop to gather the views of the Public Debt Managers (DMOs) was conducted in Dublin on 20 October 2017.

Questions asked have covered, inter alia, the following relevant issues:

1. The extent to which the current regulatory framework is seen as an hindrance against SBBS, including in terms of which specific provisions
2. What options would be favoured to address any identified regulatory hindrances.

The results of all consultation activities will be summarised in a synopsis report.

Will an implementation plan be established?

No. The changes would be immediately applicable as by their envisaged effectiveness date.

[3] See https://www.esrb.europa.eu/mppa/surveys/html/ispcsbbs.en.html.