Sovereign bond-backed securities

2018/0171(COD) - 24/05/2018 - Legislative proposal

PURPOSE: to create a framework for sovereign bond-backed securities (SBBSs), to support further integration and diversification within Europe's financial sector.

PROPOSED ACT: Regulation of the European Parliament and of the Council.

ROLE OF THE EUROPEAN PARLIAMENT: the European Parliament decides in accordance with the ordinary legislative procedure and on an equal footing with the Council.

BACKGROUND: **sovereign bond-backed securities** (‘SBBSs’) can address some vulnerabilities that have been exposed by or have resulted from the 2007-2008 financial crisis.

Reducing risks to financial stability by facilitating the diversification of banks' sovereign portfolios and further weakening the bank-sovereign nexus is of high importance for the completion of the Banking Union.

This legislative proposal is part of the Commission's efforts to enhance Banking Union and Capital Markets Union. It aims to enable the emergence of an efficient market for SBBSs over time. In turn, SBBSs could support further portfolio diversification in the financial sector, while creating a new source of high-quality collateral particularly suited for use in cross-border financial transactions.

In mid-2016, the European Systemic Risk Board (ESRB) established a high-level task force (henceforth, the ESRB task force) to assess SBBSs' merits and feasibility. The ESRB task force concluded that a market for SBBSs can develop under certain conditions. Yet, whether or not SBBSs are viable can ultimately only be ascertained by putting them to a market test. This proposal paves the way for such a market test.

A key finding of the ESRB task force, corroborated also by interactions with market participants and other stakeholders, is that the **current regulatory framework constitutes a significant hindrance to the development of SBBSs**. Under the existing regulatory framework, SBBSs would be defined as securitisation products, and hence would be treated significantly less favourably than their underlying portfolio of euro area sovereign bonds. However, due to the nature of their underlying assets and their standardised and simple nature, SBBSs carry risks that are comparable to the underlying sovereign bonds rather than regular securitisations.

The Commission will also adopt the necessary changes to the prospectus schedules and building blocks to ensure that appropriate disclosure for this new type of financial instrument, tailored to the characteristics of the product, are set out.

IMPACT ASSESSMENT: because the proposed framework only enables the private-sector led development of an SBBSs market, but does not guarantee it, the impact assessment considered two distinct scenarios to evaluate impacts, one in which SBBSs reach only a limited volume (EUR 100 billion) and a steady-state one in which they reach EUR 1.5 trillion.

As regards the impact of SBBSs on the diversification of banks' sovereign portfolios, the assessment showed that the impact would be small in the limited volume scenario, but significant under the steady state scenario.

CONTENT: this proposal aims to **provide an enabling framework for a market-led development of Sovereign Bond-Backed Securities.**

- **SBBS operation**: SBBSs would be created by the **private sector** specifically set up for the sole purpose of issuing to investors a series of securities representing claims on the proceeds from this underlying portfolio. The various securities issued would bear any **losses** from the underlying portfolio in a certain sequence (i.e., losses would accrue first to holders of sub-senior, or subordinated, securities and only after such securities have been completely wiped out would they also accrue to the holders of senior claims).
- SBBSs would not rely on any risk sharing or fiscal mutualisation between Member States. **Only private investors would share risks and possible losses**. SBBSs are therefore very different from Eurobonds.
- **Composition and structure of a SBBS issue**: the proposal provides a set of rules that define the constitutive elements of SBBSs. These rules are necessary to ensure that as standardised a product as possible is produced by the markets. This in turn favours its liquidity and appeal to investors.
- Under the proposal, the underlying portfolio of SBBSs should be composed of **sovereign bonds of all EU Member States whose currency is the euro**. A SBBSs issue should be composed of a senior tranche, corresponding to 70 percent of the nominal value of SBBSs issue, and one or more subordinated tranches. The purpose of the subordinated tranches is to provide protection to the senior tranche, which therefore is a low risk instrument.
- **Notification and transparency**: the proposal provides rules that define notification and transparency requirements for the issuing entity to ensure that self-attestation is performed in a harmonised and credible way. To ensure that investors are protected from the risk of insolvency of the institution that acquires the sovereign bonds (original purchaser, typically a bank), the issuance of SBBSs should be undertaken by a Special Purpose Entity (SPE) that is exclusively devoted to the issuance and management of SBBSs.
- The SPEs are responsible for compliance with the product and notification requirements. The European Securities and Markets Authority (ESMA) is entrusted with the publication of notifications on its website. This will ensure that the SPEs take responsibility for claiming that a product qualifies as an SBBS and that there is transparency in the market. **SPEs shall be liable for any loss or damage** resulting from incorrect or misleading notifications under the conditions stipulated by national law.
- **Monitoring**: the proposal contains rules regarding the supervision of SBBSs and possible sanctions in case of non-compliance and/or fraudulent behaviour of the issuing entity. It requires Member States to designate competent authorities in accordance with existing EU financial services legislation. The sanctions inflicted to a special purpose entity should be published. In addition, an SBBS which is found not fulfilling the requirements of the proposed Regulation should be removed without undue delay from the list of SBBS established by ESMA.

Lastly, the proposal contains a set of **amendments to the existing legal framework** required to grant SBBSs regulatory treatment in line with their unique design and properties.