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REGULATORY SCRUTINY BOARD OPINION

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

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EUROPEAN COMMISSION
Regulatory Scrutiny Board

Brussels,
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Draft Opinion

Title: Impact Assessment / Sovereign bond-backed securities (SBBS)

(version of 19 January 2018)*

Overall opinion: POSITIVE WITH RESERVATIONS

(A) Context

In the past, some EU countries have suffered from domestic banks having too much exposure to domestic government debt. Some believe this would be less likely to happen if there were an area-wide low-risk asset such as a Sovereign Bond-Backed Security (SBBS). An SBBS would ideally have minimal credit risk, low volatility, high liquidity and continue paying returns even when financial markets are stressed. Currently no such asset exists. If one did, it could improve financial stability in a financially integrated union.

There is a regulatory obstacle to SBBS. Current regulations would classify an SBBS as riskier than the government bonds that back it. The private sector would reportedly not create an SBBS unless the regulatory treatment were lighter, e.g. with regard to capital requirements. There are other considerations as well. In December 2017 the Commission said it would put forward a proposal to enable SBBS.

This impact assessment examines selected exemptions to current regulations that would support private sector incentives to create an SBBS. It draws on work of a High Level Task Force. The task force found that a gradual development of a demand-led market for SBBS might be feasible under certain conditions.

(B) Main considerations

The Board notes that the initiative relies on extensive consultations and expert input.

The report still contains significant shortcomings that need to be addressed. As a result, the Board expresses reservations and gives a positive opinion only on the understanding that the report shall be adjusted in order to integrate the Board's recommendations on the following key aspects:

(1) The report does not make clear whether this initiative aims at providing an enabling framework and market test or an incentive structure for SBBS.

(2) The report does not show how the initiative would deliver net public benefit. It does not sufficiently discuss risks or unintended consequences of SBBS. In

* Note that this opinion concerns a draft impact assessment report which may differ from the one adopted.

particular, it does not analyse the liquidity and stability risks under stressed financial market conditions.

(3) The report does not adequately present the trade-offs between alternative models and does not offer appropriate guidance for the political choice of the preferred option.

<u>(C) Further considerations and adjustment requirements</u>

(1) The report leaves unclear whether this initiative and the proposed options provide merely an enabling framework or also market incentives to SBBS. In case the intiative intends to set an enabling framework and to test the market, the report should clarify the (limited) risks in case the market for SBBS would not develop. Furthermore, the report should discuss for each option the extent to which it would offer prudential incentives for some market participants to hold SBBS. The discussion on which stakeholders prefer which option needs to reflect these considerations.

(2) The baseline should be corrected to consistently be the projection of the 'no policy change' scenario, including any potential implications of ongoing EU or international initiatives. It should also serve as the comparator of the different options.

(3) The estimated cost-savings of €70 billion are misplaced in the comparison table in Annex 3 because they are virtual cost savings.

(4) The impact assessment has to clarify the intervention logic and reconcile the SBBS objectives (p7) with the specific objectives of the regulatory treatment and the final impact assessment (table 4 page 41).

(5) An assessment of unintended consequences and risks, in the case that SBBS are successful and their market becomes liquid, is lacking in the report. The report should include a discussion of the likely consequences for and the reaction of SBBS holders (of senior and junior tranches) and for the wider bond market, in the event of a severe financial crisis. The discussion should take into account the different characteristics of the proposed options.

(6) The report should explain how the Commission (or ESMA) will set the tranching point, prescribe the weighting of underlying bonds, etc. in order to arrive at a standardized product, including the related considerations regarding adjustments vs. safeguards.

The feasibility of keeping (the senior tranch of) SBBS at a AAA rating in these circumstances needs to be assessed for the envisaged options. Diverging views on this issue and the profitabililty of investing in SBBS have to be taken into account.

(7) The report does not discuss in sufficient depth the high correlation of the bonds underlying the SBBS and the implications for the SBBS's added value in diversifying risk. If the risk diversification delivered by SBBS is limited, the report should explain what that implies for their contribution to reducing the home bias and its consequences in the investment in bonds by banks.

(8) The section on the preferred option does not adequately discuss the trade-offs between models 1, 2 and 5. The comparative analysis seems to show that model 5 is inferior to models 1 and 2. The option of retaining model 5 should therefore either be abandoned or further substantiated. The report should also elaborate further on the relative effectiveness and regulatory neutrality of models 1 and 2, in order to provide a more informed guidance on the choice of the preferred option.

The Board takes note of the quantification of the various costs and benefits associated to the identified policy options for this initiaitve, as assessed in the report considered by the Board and summarised in the attached quantification tables.

(D) RSB scrutiny process **The lead DG shall ensure that the report is adjusted in accordance with the recommendations of the Board prior to launching the interservice consultation.** **The attached quantification tables may need to be adjusted to reflect the choice and the design of the preferred option(s) in the final version of the report.**	
Full title	Impact Assessment on a proposal for an enabling regulatory framework for the development of sovereign bond-backed securities (SBBS)
Reference number	PLAN/2017/1678
Date of RSB meeting	14 February 2018

ANNEX: Quantification tables extracted from the draft impact assessment report submitted to the Board on 19 January 2018

Table 5: Overview of the benefits

I. Overview of Benefits (total for all provisions)		
Description	***Amount***	***Comments***
Direct benefits		
Eliminated regulatory surcharges	*Capital requirements*: relative to the current regulatory framework, the 105 banks of the EBA transparency exercise 2015 would save up to **EUR 70billion**. Solo insurance companies would save up to **EUR 963billion** *Liquidity coverage requirements:* banks would be able use these new products to meet liquidity coverage requirements, which is not possible under the current regulatory framework. This benefit would increase with the volume of the new instrument.	These figures assume that banks/insurance companies replace their sovereign portfolio with the senior SBBS tranche compared to the current situation, where they hold sovereign bonds which enjoy a specific regulatory treatment (see also annex 4).
A new product becomes available	EUR 100 billion to EUR 1,500 billion	A new instrument would become available for banks, insurance companies, pension funds and other investors. Two scenarios have been analysed. A "limited" scenario, in which SBBS develop very gradually and reach a limited volume and a "steady state" one where SBBS reach a macroeconomically significant volume. The actual scale of the SBBS market will depend on the instruments' overall attractiveness for the market.
A more stable financial system	#NA.	A quantitative assessment is difficult, because of the significant uncertainty on the extent to which the market would develop. Nevertheless, from a qualitative perspective, the new instrument could contribute to financial system stability at large as it would weaken the bank-sovereign loop. Further, as a share of the outstanding sovereign bonds would be held in SBBS portfolios, these bonds would not be quickly sold off in times of financial market stress.

Expand the investor base for European sovereign debt	#NA.	A quantitative assessment is difficult, because of the significant uncertainty on the extent to which the market would develop. Nevertheless, from a qualitative perspective, benefits could be large. In particular for smaller Member States whose sovereign bonds may not be on the radar screen of investors, demand coming from the SBBS issuer would facilitate Debt Management Offices debt placements.
Indirect benefits		
Indirect benefits on retail investors, households or SMEs	#NA	These sectors do not benefit directly as they are unlikely to be active in the SBBS market. They might benefit indirectly – including from enhanced confidence and lower borrowing costs – to the extent that the above-mentioned benefits in terms of enhanced financial stability materialise.

Table 6: Overview of the costs

II. Overview of costs								
		Citizens/Consumers		**Businesses**		**Administrations**	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
For all considered models	Direct costs	None	None	None for SMEs and other Non-Financial Corporations For issuers of the new product, see table Table 9	None for SMEs and other Non-Financial Corporations For issuers of the new product, see table Table 9	Creation of a new legislation	Supervision of SBBS (depending on the model, these costs range between limited and moderate)
	Indirect costs	None	If the introduction of SBBS were to impact sovereign bond market liquidity, this could lead to higher financing costs for Debt	None	None	None	None

			Management Offices which would in the end be carried by the tax-payer.				