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European Safe Bonds: An ambitious project

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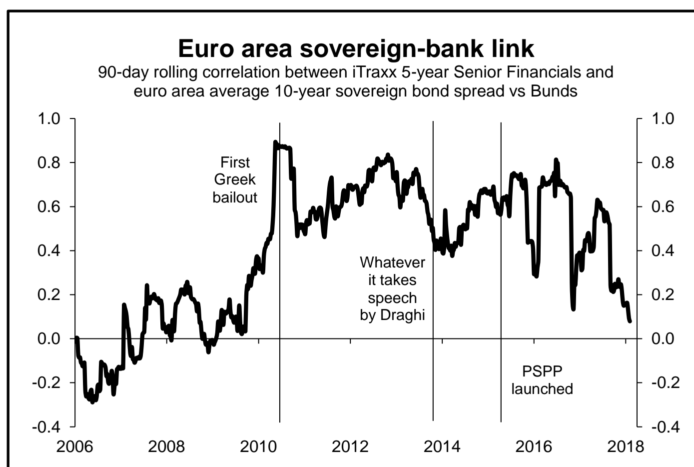
- Last week, the European Systemic Risk Board published a study on the viability of a euro area wide safe asset, the Sovereign Bond-Backed Security (SBBS), engineered via the pooling and tranching of euro area sovereign bonds. It aims at weakening the potential bank-sovereign doom loop and fostering financial integration.
- To exploit the full benefits of the SBBS, far-reaching legislative changes are needed, e.g. senior tranches need to be eligible as ECB collateral and treated as sovereign bonds in the balance sheet of banks and insurance companies.
- However, the crucial creation of a market for the junior tranche cannot be taken for granted: Bank profitability especially in peripheral countries would suffer. Moreover, in times of stress, the issuance of SBBS would become difficult, especially if a large country is affected. Finally, the need for unanimous support from national governments requires that each country is not worse off. Ensuring this may complicate the process.

The euro crisis cast doubts about the longer term existence of the EMU, bringing the severe shortcomings of its construction to the fore. Attempts to improve fiscal coordination led to the Fiscal Compact and the legislative process towards a banking union that is scheduled to enter its final stage in 2019. Further fiscal integration and debt mutualization are being discussed, but do not appear politically feasible for the time being.

A key issue to be resolved is the large home bias in sovereign bond investment by banks. This is particularly evident in Southern European countries, whose holdings of domestic government securities are still almost four times as large as those of AA-or-higher-rated countries in terms of share in total assets.



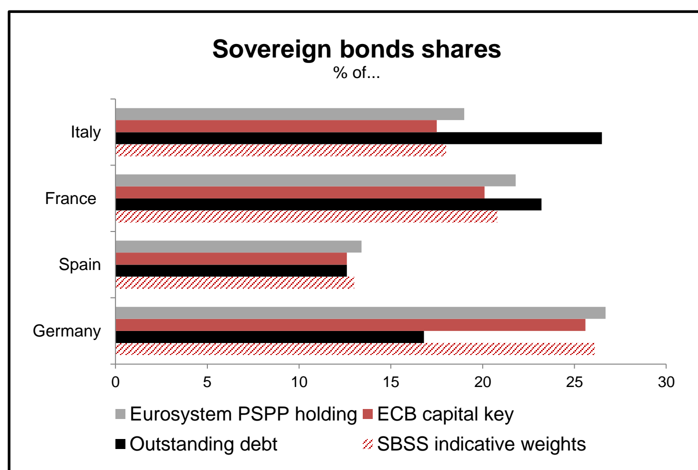
A tight sovereign-bank nexus in a less than complete banking union will amplify the impact of fiscal crisis on the financial sector. Several proposals have been put forward on how to cut this link between sovereigns and the banking sector and improve financial stability.

An innovative approach which has gathered attention is the creation of synthetic European Safe Bonds or Sovereign Bond-Backed Securities (SBBS). The idea is to bundle together sovereign bonds from different countries and create tranches with different risk profiles. The ECB's European Systemic Risk Board (ESRB) launched a study in 2015 on how such an asset could be conceived and its conclusions were published last week. In what follows, we sketch the main points and discuss merits and shortcomings.

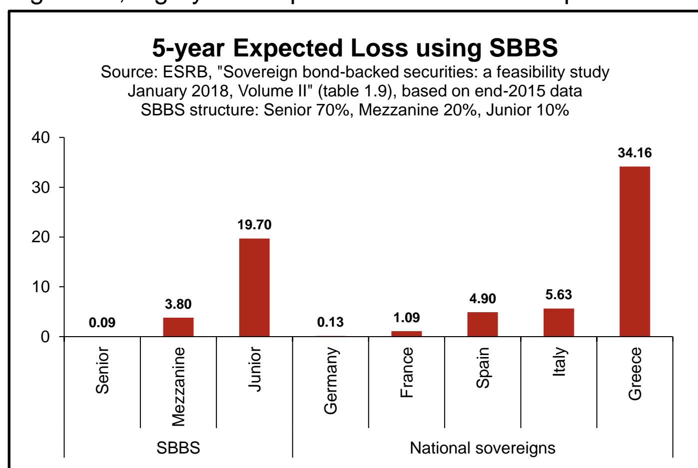
How a European Safe Bond would work

Technically, SBBS are thought as claims on an underlying portfolio of euro-denominated sovereign bonds, issued by EU member states, whose debt is exchanged at market prices. The ESRB suggested focusing on central government securities only, a market north of €7 trillion. They would be bundled (leading to risk diversification) and the resulting pool divided in tranches, with different degrees of risk. According to the ESRB proposal, the weights of the underlying portfolio would be based on the ECB capital keys, allowing for just minor deviations to accommodate for countries with too little outstanding debt. Sovereign bonds would be purchased at market prices, to ensure a strong relation between the pool and the securities backed in the portfolio, and to avoid that SBBS function as a risk

management tool or a way to fund troubled illiquid governments.



Diversification alone is not enough to generate a low risk portfolio. In order to facilitate de-risking, the SBBS would allocate the cash flows from the pool to three assets with **different levels of seniority**. Any losses to the pool (due, for example, to a partial default) would first be borne by the holders of **junior** SBBS. Should these be totally depleted, a **mezzanine** layer would take the residual losses, in order to protect the **senior** tranche. According to simulations carried out by the ESRB, a product constituted by a 70% of senior layer, a 20% mezzanine and 10% junior ones would result in the senior tranche embedding expected losses similar to those of German Bunds. The mezzanine tranche would have a risk profile similar to that of lower IG sovereign bonds, and therefore would be purchasable by investors with rating based restrictions. The junior tranche would be significantly more risky and will probably have a low junk-rated profile. Given the likely higher risk premiums, it could be attractive for those investing in EM sovereign debt, high yield corporates and structured products.



The pools would be built by so called "arrangers", legally independent from the bond issuers. They would collect the orders from the investors, build the pool and transfer its ownership to another entity in exchange for a replicating portfolio of senior, mezzanine and junior SBBS. The use of another entity is meant to protect investors from the (unlikely) default of the arranger.

According to the ESRB, arrangers could be both public and private. Private entities would need ad hoc regulation and require compensation for costs and warehousing risks, but these should be relatively small. A wholly or partially public arranger would need an institutional framework regulating, among other things, the size of the public capital injections, which would lead to some form of debt mutualization.

In order to minimize warehousing and placement risks, the assembly of a SBBS would occur only after a binding order book including all the tranches is completed. This means that, in times of stress, the lack of buyers for the junior tranche may prevent the issuance of the whole product.

In case of debt restructuring, bonds included in SBBS would be treated in the same way as those held by other investors. In case of a bond swap, the old securities will simply be replaced in the SBBS pool.

Regulatory overhaul crucial to create the market

In order to fulfill their risk reduction purposes, the size of SBBS outstanding would have to be quite large. However, stimulating demand would require a comprehensive overhaul in regulation. The current framework would treat SBBS as securitized products, leading to a sharp disadvantage with respect to sovereign bonds in terms of capital and liquidity requirements for intermediaries willing to invest in them. Moreover, they would not be eligible as collateral by the ECB, since sovereign bonds are not in the list of assets that may underlie Asset Backed Securities.

The ESRB argues that many of the sources of securitization-specific risk are absent in SBBS. The underlying assets are liquid, well known and simple to understand. Moreover, the use of predetermined country weights rules out adverse selection. Therefore, **legislation specific to SBBS would be needed**, the ESRB reckons. According to its statistical analysis, thanks to its risk profile, senior SBBS could be awarded a risk weight of zero and would qualify, like sovereign bonds, as a most liquid asset under liquidity coverage requirements. The stabilizing role of SBBS would be greatly enhanced if the senior tranche were considered by the ECB as eligible collateral. This could be possible by including sovereigns as collateral for ABS and adjust the haircut schedule in accordance with the lower risk profile of the underlying sovereign bonds.

Regulatory changes would require the unanimous approval by all the euro area members. National governments, especially those in core countries, must be convinced that they are not worse off compared to the current situation and, most importantly, that SRRB are not an indirect way to mutualize sovereign debt. Here, the risk is that markets would perceive SBBS as 100% safe and expect a bailout if it worse comes to worse. Particularly in case the so-called arrangers are public entities this could trigger expectations that steps to avoid payment defaults and/or compensate investors will be taken by EU institutions in case of market turmoil.

In principle, according to the ESRB document, market discipline would be maintained as bonds would continue to be purchased at the going price and the cash flows originated by SBBS would not carry any guarantee, neither by the originator nor by EU institutions or member states. However, a large degree of public involvement in the SBBS market, via, for example the setup of publicly owned originators, may still lead to the misperception of an implicit bailout. The ESRB stresses the need of government communicating its commitment to no bailout, which however would have to be stated very clearly in the legislation. A

convincing self-commitment will be difficult to achieve as in the past European institutions repeatedly have come under pressure during the debt crisis to not enforce the existing rules and procedures. Moreover, countries with weaker fiscal positions may fear to face higher interest rates on their junior debt.

Junior tranche market difficult to create

The treatment of mezzanine and junior tranches is much less well defined. The ESRB generically calls for risk weights and/or position limits reflecting their relative riskiness and lower liquidity. With banks and insurance companies incentivized not to buy the junior tranche the question is who would be willing and able to buy it so that it remains to be seen whether a liquid market can be created.

The ESRB estimates that SBBS can absorb up to €1.5 trillion in central government securities. This would imply a junior tranche of around €150 bn with a likely rating in the single-B category. For a comparison, the size of the Greek government bond market (excluding T-bills) is around €50 bn, while the EUR-denominated corporate bonds with a rating of single-B or lower have an outstanding of €75 bn. With no demand for the junior tranche in time of crisis, the availability of SBBS could become procyclical, reducing their usefulness.

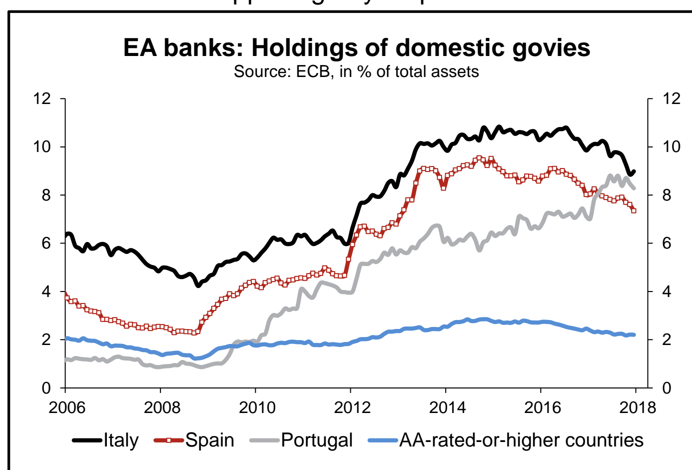
SBBS exhibit limitations

When assessing European Safe Bonds it is important to keep in mind that they are meant to separate sovereign from banking sector risk but that it will not prevent the next sovereign crisis. Financial products cannot be substitutes for fiscal policies. Their design has to be crafted carefully in order not to undermine the incentives for sound economic policymaking.

Moreover, the equivalence of the most senior tranche with AAA bonds may be tested should a large default by individual countries require more resources than those provided by the junior and mezzanine tranches. Uncertainty on that would lead investors to shift from Senior SBBS to highly rated bonds in times of stress.

Additionally, and more generally, demand from banks in peripheral countries cannot be taken for granted. Shifting from local bonds to lower yielding SBBS would harm profitability. Another obstacle to demand, regardless of the regulation, is that SBBS would generate new costs and would introduce counterparty risks which are not existent in the plain vanilla trading of government bonds. The fact that unregulated participants in financial markets have not asked for the creation of SBBS calls into question the demand of such products.

Another important issue is whether and how the SBBS implementation would overlap with other policy initiatives being discussed. For example, the review of the regulatory treatment of foreign exposure kick-started by the Basel Committee has, among the many alternative suggestions, the possibility to introduce positive risk weights for sovereign exposure, to mitigate credit and concentration risks. Such a provision would increase the appeal of SBBS, as banks and insurers could use it to mitigate the impact on capital requirements. However, these constraints would have to be accounted for in the way weights for SBBS pools are computed, possibly making the process less transparent. Moreover, the departure from non-zero risk weights for sovereigns remains very controversial, with several countries opposing any step into this direction.



Conclusion

SBBS constitute an ambitious step towards tighter financial integration in the euro area. Together with some measures already envisaged, like the common deposit scheme, expected to be passed this year (on a forward basis), they could become an important tool of crisis prevention and ease the transmission of the ECB’s monetary policy.

However, getting to the implementation would require a strong commitment by all the Eurozone states on far-reaching legislative changes. Forging the required consensus demands a clear proof that all countries would be at least not worse off with the SRRB and that debt mutualization will be avoided. This appears hard to achieve given the low commitment to stick to fiscal discipline. In this sense it is important to note that the SBBS initiative has the support of the European Commission, but no national government has so far sponsored it.

In the end, however, the choice between synthetic products or technically simpler but politically more contentious ways to reduce systemic risk, like country-specific risk weights to sovereign bonds, will be largely a political one. Having said this, the timing of the ESRB report is very appropriate, as the very good economic outlook for all the euro area members and the Franco-German push towards further integration create a favorable climate for discussion.

Imprint

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