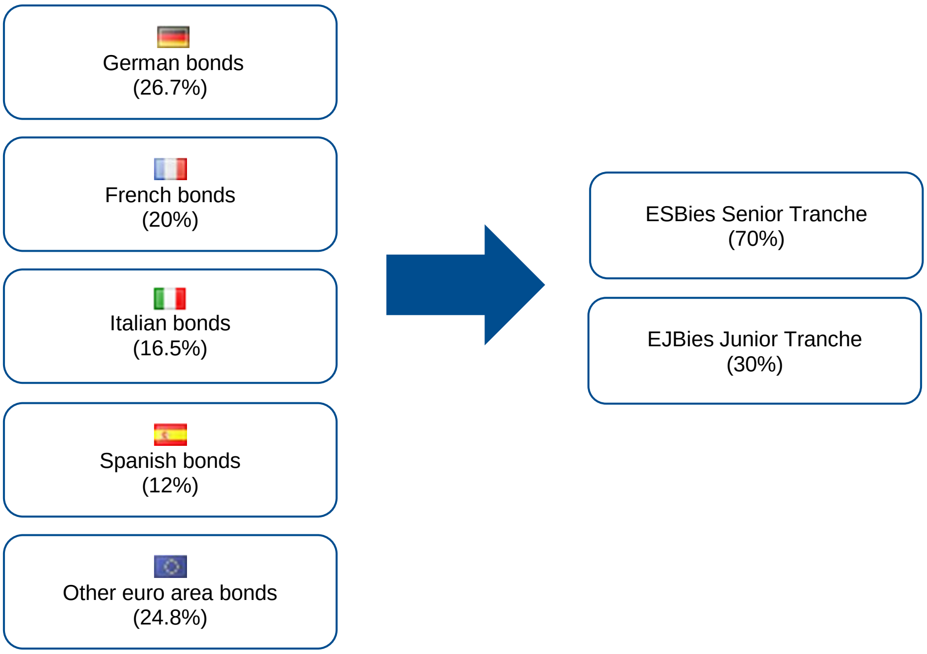
Scope: Can sovereign bond-backed securities be the safe asset the euro area wants?

The creation of European Sovereign Bond Backed Securities (SBBS) offers a likely improvement to the euro area's institutional framework, enhancing financial stability by supporting increased banking sector portfolio diversification and improving market access for euro area countries. However, Scope also sees obstacles to SBBS implementation with limited political support and questions about how SBBS would function.

What are SBBS and why would Europe need them?

Several proposals to create a public "safe asset" for the euro area have been put forward at various stages of the euro area sovereign debt crisis of 2011-2013 [1]. A new legislative proposal to introduce sovereign bond-backed securities was presented by the European Commission (EC) on May 24, following up on a report by the European Systemic Risk Board (ESRB) published earlier this year. Such securities backed by a diversified portfolio of euro area central government bonds have been proposed as a solution to help banks diversify their sovereign exposures ("sovereign-bank nexus") and further weaken the link with their individual sovereigns.

Compared with other proposals, such as Eurobonds or Blue-/Red-Bond proposals, both with joint liability among sovereigns, SBBS would have the advantages of: (i) creating safe assets without resorting to any mutualisation of debt between countries, (ii) reducing investors' bias towards their own countries and increasing the financial stability of the euro area, (iii) deepening Europe's capital markets by creating an alternative large and liquid benchmark instrument, and (iv) posing no threat to fiscal discipline as each sovereign would still be individually responsible for its own government bonds.



[1] See Leandro and Zettelmeyer, 2018, for an extensive review of the main proposals.

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The EC's proposal on SBBS

Under the EC's latest proposal, governments will not be allowed to issue bonds under joint liability. Instead, member states will continue to issue their own bonds, which will then be bought on the secondary market, restructured and sold as SBBS in two tranches as described below. The proposal assumes that senior SBBS enjoy the same preferential treatment for capital requirements as government bonds.

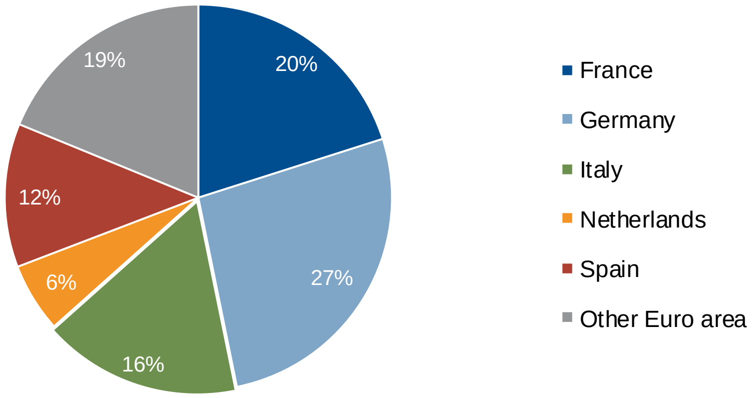
The authors of the SBBS idea[2] established a design with two different types of bonds: The first type constitutes a safe security (ESBies), which is backed by 70% of the underlying euro area government bonds (70 cents of the nominal value of the issuance) with country weights largely corresponding to the ECB's capital key. The remaining 30% constitutes a subordinate and riskier security (EJBies). The latter is designed to protect holders of the more senior ESBies and targets investors in search of yield. Compared with other prominent ideas such as the Blue-/Red-Bond proposal[3], the SBBS framework distinguishes between senior (blue) and junior (red) debt, however, without pooling debt under joint liability (as in the blue bond proposal).

The securitisation agency can also freely decide on the number of securities supplied and thus ultimately on the amount of acquired government bonds. It has to consider only the requirement to buy fixed volumes of bonds from each country as defined by the capital shares (see **Figure 1**). This rule ensures that the upper bound for the volume of SBBS is set by German debt. This bound leads to a maximum SBBS volume of 5tr. Euro.[4] Using central government debt figures from 2015, Germany is the only country able to transform all its debt into SBBS (**Figure 2**). Other members continue to issue a part of their debt as single bonds, depending on their capital key and indebtedness. Regardless of whether the bonds are sold as SBBS or single bonds, national governments continue to issue all their debt under full liability, flanked only by the securitisation agency that offers SBBS on the secondary market as an alternative to traditional sovereign bonds. Scope expects that this distinction is vital for the acceptance of SBBS by governments such as Germany.

The ESRB has conducted several stress scenarios based on the original academic proposal[5]. Assuming a capital weight guided by the European Central Bank's capital key and the suggested subordination level of 30% results in loss-scenarios for SBBS that are more robust for the senior tranche than default scenarios for any individual sovereign, including Germany. This makes the senior tranche particularly attractive for banks, whereas the junior tranche may be held only by banks and insurance companies with sufficient underlying capital. In addition, the structure of SBBS is far from complex, considering the securities are backed only by euro area government bonds that have publicly available market prices.

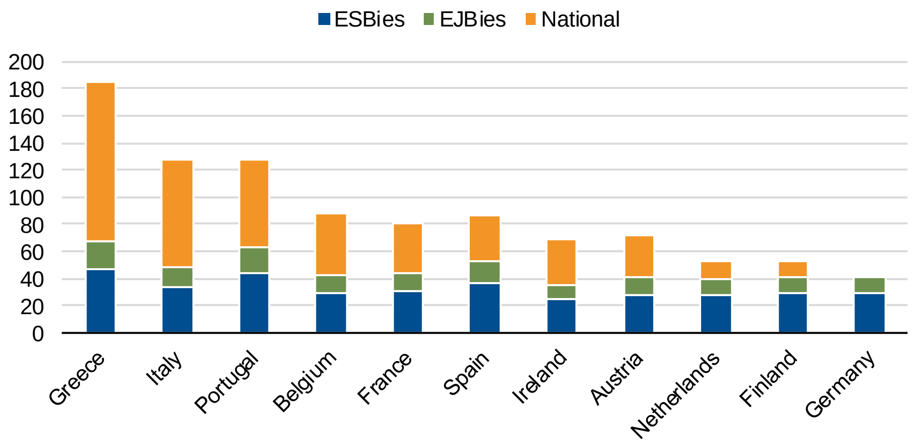
[2] The idea of SBBS was introduced by researchers centered around Markus Brunnermeier, a Princeton University-based German economist.
[3] The Blue-Bond proposal was developed by Jacques Delpla and Jakob von Weizsäcker at Bruegel (http://bruegel.org/wp-content/uploads/imported/publications/1005-PB-Blue_Bonds.pdf).
[4] See the appendix for further details
[5] The ESRB has published three working papers on the riskiness and spillover effects of SBBS (No. 65-67, January 2018), https://www.esrb.europa.eu/pub/series/working-papers/html/index.en.html.

Figure 1: SBBS asset composition % of adjusted ECB share capital[6]



Source: European Central Bank, Annual Report 2017, own calculations

Figure 2: Composition of central government debt in the euro area with SBBS



Source: Haver analytics, own calculations

Who benefits from the introduction of SBBS?

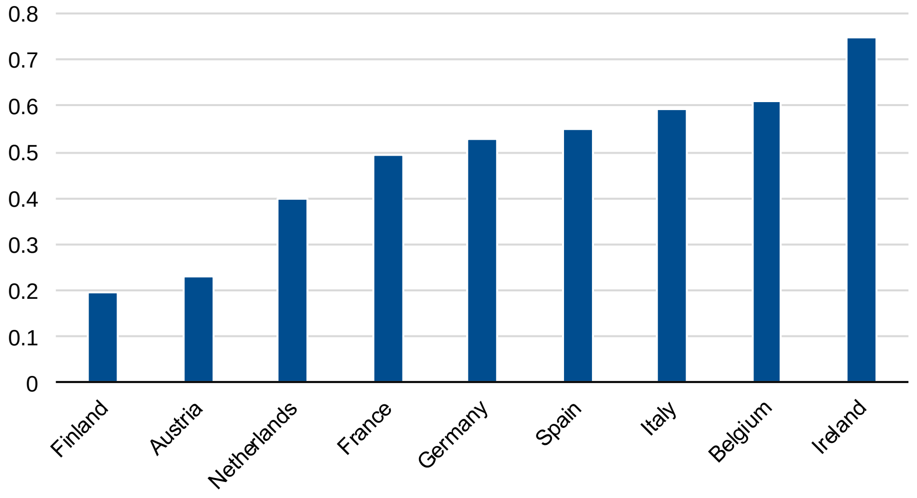
Scope sees a major advantage with SBBS for participating governments in view of the expected higher liquidity and safety provided by a euro-area-wide asset. Central banks and financial markets need safe assets to use them as collateral and to satisfy funding needs during periods of stress. The most widely held safe assets are issued by the US Treasury department in the form of bills and bonds. During the Global Financial Crisis and in the subsequent European sovereign debt crisis, market participants realised the existing scarcity of safe assets, which resulted in negative interest rates for “safe haven” assets such as German government bonds.

Another key argument in favour of SBBS is the expected movement towards deeper capital market integration in the currency area by reducing the “doom loop” between sovereigns and individual banks (the “sovereign-bank nexus”). Marketable SBBS shall allow banks to better diversify their risk exposures via a portfolio of euro area bonds instead of holding mainly government bonds from the sovereign. Also, the two tranches would allow banks to diversify based on their risk tolerance.

[6] The capital shares are calculated as equally weighted averages of GDP and population as of 2017 while ignoring non-EMU members.

Scope believes that euro area banks can reduce their current exposure to bonds issued by their respective governments, especially in highly indebted countries such as Italy or Spain. According to the EU bank stress test in 2016, domestic banks of each country currently absorb on average 48.3% of national debt held by European banks. Irish banks come out with the highest absorption rate (75%), whereas Finland and Austria manage to export a relatively large share to other EU countries. A swap of national government bonds for senior SBBS is expected to reduce the exposure of banks without affecting capital requirements unless they acquire securities from the junior tranche. Scope provides a scenario analysis in the appendix of this comment. It shows that the impact of SBBS for bank exposures under an assumption that 100% of German central government debt is placed under SBBS. Under this assumption, domestic banks can reduce their exposures to the national sovereign from an average of 48% down to 20% by substituting national government bond holdings with SBBS.

Figure 3: Share of total sovereign debt held by domestic banks



Source: European Banking Authority, data from bank stress test, June 2015

Finally, the distinction between senior and junior tranches of SBBS ensures that regulated financial institutions hold adequate capital ratios relative to their assets. Whereas the senior tranche should be held primarily by banks and insurance companies, the riskier junior securities should be attractive instruments for hedge funds and other investors in search of yield. The default of a country or even multiple defaults would thus first lead to losses among alternative investment and risk-seeking institutions, whereas purely depository institutions remain protected by the senior tranche.

What are the major drawbacks?

First, the current regulatory requirements prevent banks from holding SBBS instead of pure government bonds[7]. At the moment, sovereign bonds would enjoy favourable regulatory treatment compared with SBBS in terms of liquidity and capital requirements, which makes SBBS unattractive for banks. Scope notes that a market would already exist for structured products based on sovereign debt if there had been sufficient demand. The EC proposal aims at closing this regulatory gap by proposing lower capital requirements for banks that hold these securities. This proposed regulatory treatment is a major pre-condition for the successful implementation of SBBS because banks would have little incentive to buy the same assets with higher capital requirements.

[7] See Lane, P. and S. Langfield: The feasibility of sovereign bond-backed securities for the euro area, https://voxeu.org/article/feasibility-sovereign-bond-backed-securities-euro-area, February 2018.

Secondly, the introduction of SBBS does not resolve the structural fiscal problems of member countries and it is not supposed to. Scope expects neither a major positive impact on the high debt ratios of heavily indebted countries nor an automatic increase of fiscal space. Our scenario analysis results in a debt composition in which countries such as Italy and Greece must refinance more than 60% of their debt on a stand-alone basis whereas lowly-indebted countries such as Finland or the Netherlands retain small shares of 20-25% of GDP.

Thirdly, SBBS remain untested. Policymakers and market participants have expressed their concerns about: (i) technical issues (pricing, replacing government bonds with SBBS in bank books), (ii) the high correlation of default risks among euro area issuers, leading rating agencies to assign ratings below AAA even to the senior tranche, (iii) insufficient market demand for the junior tranche due to its riskiness, and (iv) and high costs of securitisation. A small volume of SBBS will then not provide the desired liquidity of a safe asset.

Fourthly, banks can diversify their portfolios of euro area government bonds already today. One reason why they do not is the lack of sufficient capital market integration in the EU. A successful implementation of SBBS therefore requires parallel progress on the European deposit insurance scheme and the Single Resolution Mechanism.

Finally, and most importantly, the proposal is politically controversial and still lacks support from the German government, the euro area's largest issuer, among others. Opponents to SBBS fear that the securitisation scheme is nothing else than the introduction of joint-liability euro bonds through the backdoor. Aside from these fears, the German government might lose its privilege as the safe haven destination because markets could resort to SBBS – which are primarily backed by German bonds.

While sharing the view of the limited chance for SBBS to be realised any time soon, Scope expects that market demand would be of less concern if regulatory reform succeeds. Technical difficulties and insufficient demand in the early stages after introduction is a concern; however, Scope believes that the instruments could be accepted by market participants over the medium term as a valid substitute to sovereign bonds based on the ability of investors to choose among more options than today: a pure government bond, a low risk security backed by euro area government bonds, a higher risk security backed by euro area government bonds or a mixture of the three.

What would be the impact of SBBS on Scope's sovereign ratings?

Scope believes that the overall impact of a successful SBBS introduction on its sovereign ratings would be a small credit positive.

First, the new instruments – especially the senior tranche – would create additional liquidity and thereby facilitate market access and extend funding sources for euro area sovereigns. SBBS would allow governments to refinance debt at low rates and to benefit from the higher use of the senior tranche as a safe haven asset (and possible substitute for US treasuries).

Secondly, in contrast with other proposals that require treaty change, a failure of a sovereign bond backed security creates no additional losses compared with the status quo; thus, no treaty change is necessary for the implementation of SBBS. The substitution of national government bonds with structured SBBS can be implemented step by step to prevent market distortions after introduction. Capital markets can freely decide if they take up the new security or continue to hold the issued bonds directly.

Finally, Scope expects no significant impact of the SBBS' introduction on refinancing rates for Germany or the Netherlands. Whereas these countries may experience somewhat lowered "safe haven" demand during stress periods, they are expected to benefit from better integrated capital markets and a safe asset (senior SBBS) during normal times, which would contribute to lowering refinancing rates.

However, Scope notes that the successful introduction of SBBS crucially depends on the ability of the EU institutions to convince member states of the advantages of preferential regulatory treatment of SBBS.

Appendix: The composition of sovereign debt across governments and banks under SBBS – A scenario analysis

1. Key assumptions

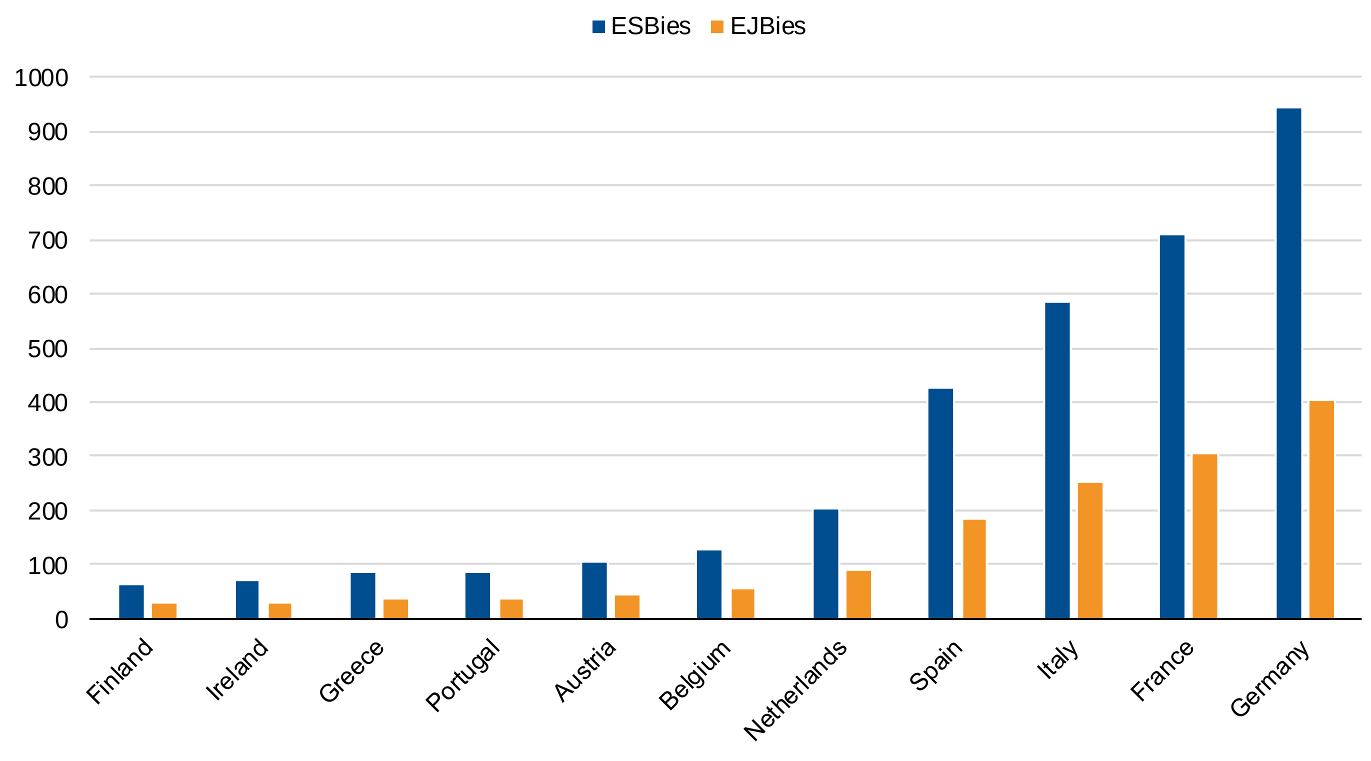
- Sovereign debt shares in ESBies and EJBies are defined according to the ECB's capital key but recalculated ignoring non-euro area members
- Scope uses current values to calculate the equally weighted average of population and nominal GDP for the capital shares (based on 19 euro area member countries)
- Following the proposal by the European Commission, 70% is invested in ESBies, with 30% in the subordinated EJBies
- Germany contributes 100% of central government debt to the senior and junior tranches:
  - EUR 1.35tn (41% of national GDP)

2. Composition of central government debt under SBBS

The composition of debt in the three categories as shown in Figure 2 (see page 3) is based on the following calculation:

- Total German central government debt constitutes 26.7% (EUR 1.35tn) of the SBBS portfolio according to the nation's capital key and constitutes the upper bound for SBBS' total volume:
  - Senior tranche: EUR 3.5tn
  - Junior tranche: EUR 1.5tn
- Other countries fill up the basket according to their capital shares
- The residual must be financed as before on secondary markets (orange bar)
- Figure 4 shows the resulting debt composition of the two SBBS tranches

Figure 4: Volume of SBBS securities in the two tranches (ESBies, EJBies)



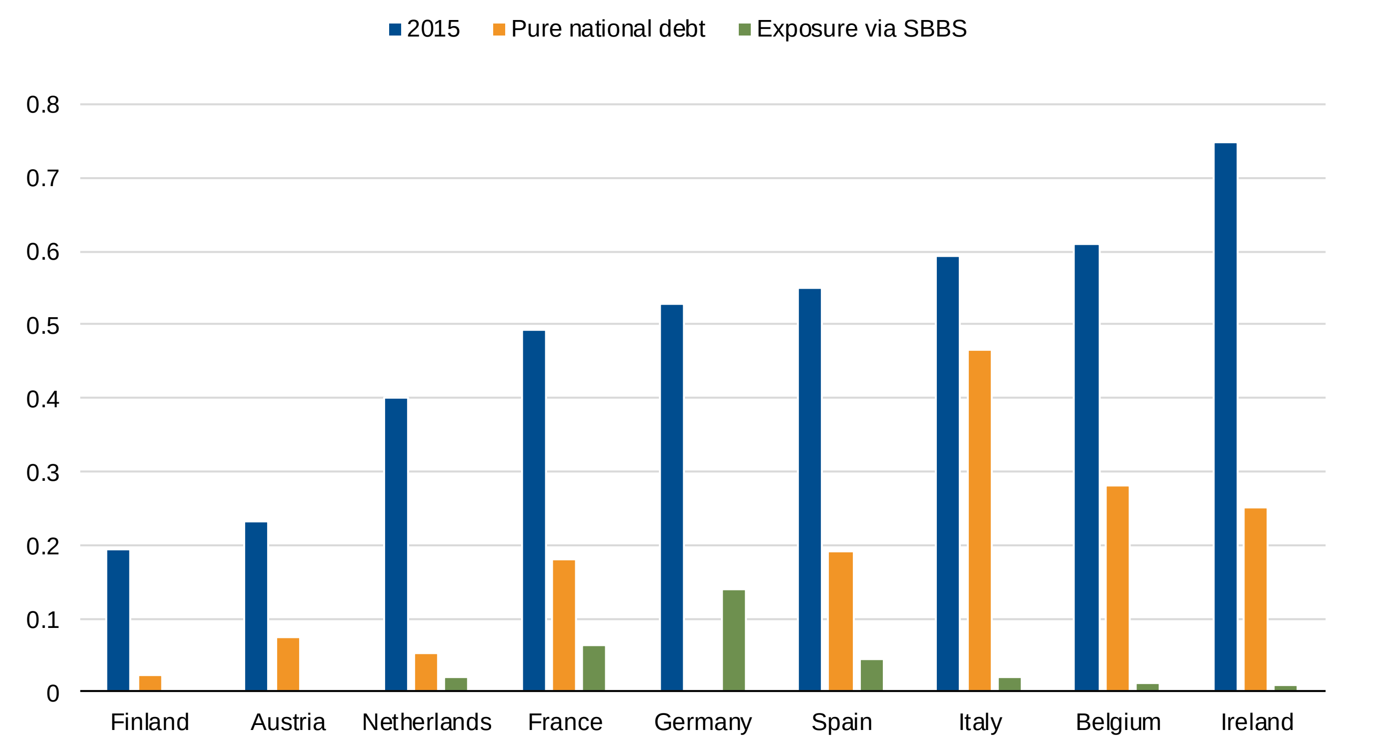
Source: Haver analytics, own calculations

3. Composition of domestic banks' sovereign exposures under SBBS

The exposure of domestic banks to their own sovereign's debt changes as follows:

- Blue bar: Exposure of domestic banks to national sovereign debt according to stress test results by the European Banking Authority in 2015
- Orange bar: Remaining exposure due to "debt overhang" after allocation to SBBS (old exposure share * remaining debt share)
- Green bar: New exposure resulting from the country weight in SBBS (capital key * sovereign debt share invested in SBBS)

Figure 5: Exposure to domestic sovereign debt held by banks



Source: European Banking Authority, data from bank stress test June 2015, own calculations

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