ESRB
European Systemic Risk Board
European System of Financial Supervision

ESRB High-Level Task Force on Safe Assets

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Safe assets: general issues

- **Sovereign bonds: benchmark assets**
  - Large stock; trading liquidity; common information base
  - Collateral function in many market transactions
- **Sovereign risk**
  - Multi-country monetary union; national fiscal liabilities (no joint mutualisation)
  - Nexus between bank risk and sovereign risk at national level

How to square this circle in the euro area?

A possible path to safe assets in the euro area

- **Sovereign bond-backed securities (SBBS) create "safety" by contract rather than by mutualising risk**
  - Pooling and tranching of cross-border portfolios of national sovereign bonds
- **Properly designed, SBBS could support financial stability by helping complete banking and capital markets unions**
- **Reduce systemic risks by weakening the bank-sovereign nexus**
  - Combination of diversification and de-risking of bank sovereign bond portfolios
- **Reduce barriers to further financial integration**
  - SBBS could be used to collateralize area-wide transactions
  - A mature SBBS market could provide an area-wide benchmark for asset pricing
- **But SBBS not a panacea: they stand alongside other policy initiatives to complete BU and CMU and deepen EMU**

ESRB High-Level Task Force on Safe Assets

- **In June 2016, the ESRB General Board established a High-Level Task Force** “to further investigate the empirical and practical considerations” related to SBBS

- **HLTF’s contribution is technical**: sheds light on unique properties of SBBS and their potential role in enhancing financial stability

- **Two-volume report summarises the HLTF’s findings**:
  - Vol. I (50 pp): motivation; security design; market development; regulation
  - Vol. II (240 pp.): risk measurement; contractual features; market intelligence; market liquidity; and a more detailed analysis of regulation

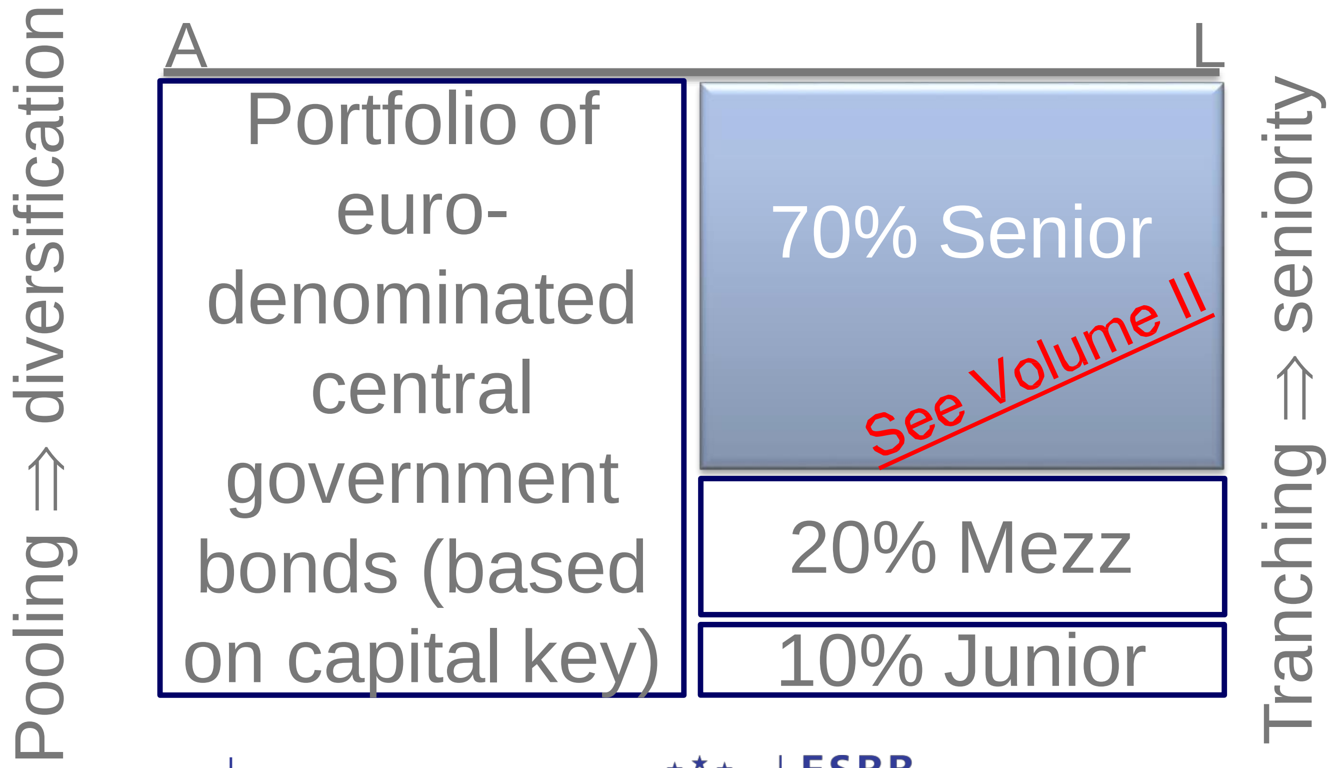
HLTF's main finding: there are regulatory barriers to SBBS

- SBBS represent one interesting and attractive option for the design of an area-wide low-risk asset
- Gradual development of a demand-led market for SBBS may be feasible under certain conditions
- One necessary condition is for an SBBS-specific enabling regulation to reflect the unique design and risk properties of these securities
- The level of investor demand for SBBS is an empirical question, which can only be tested by removing regulatory impediments

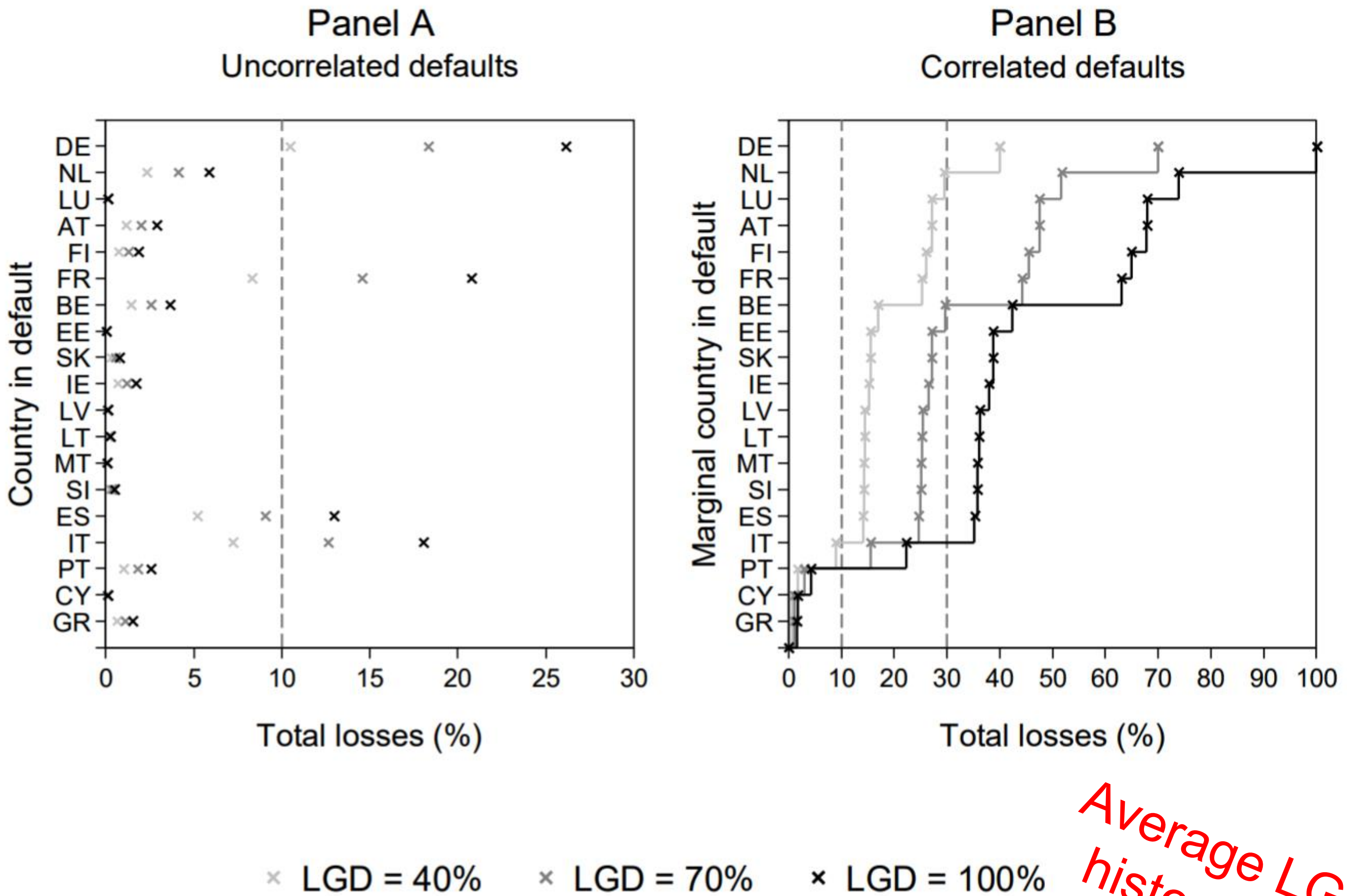
Basic security design reflects policy objectives

Security design is a policy choice:

- On asset side, designed to be area-wide
- On liability side, designed for senior to be low risk (based on Volume II simulations) and non-senior to be marketable (based on market intelligence)



Risk properties of SBBS: insights from default simulations



Average LGD in history = 37%

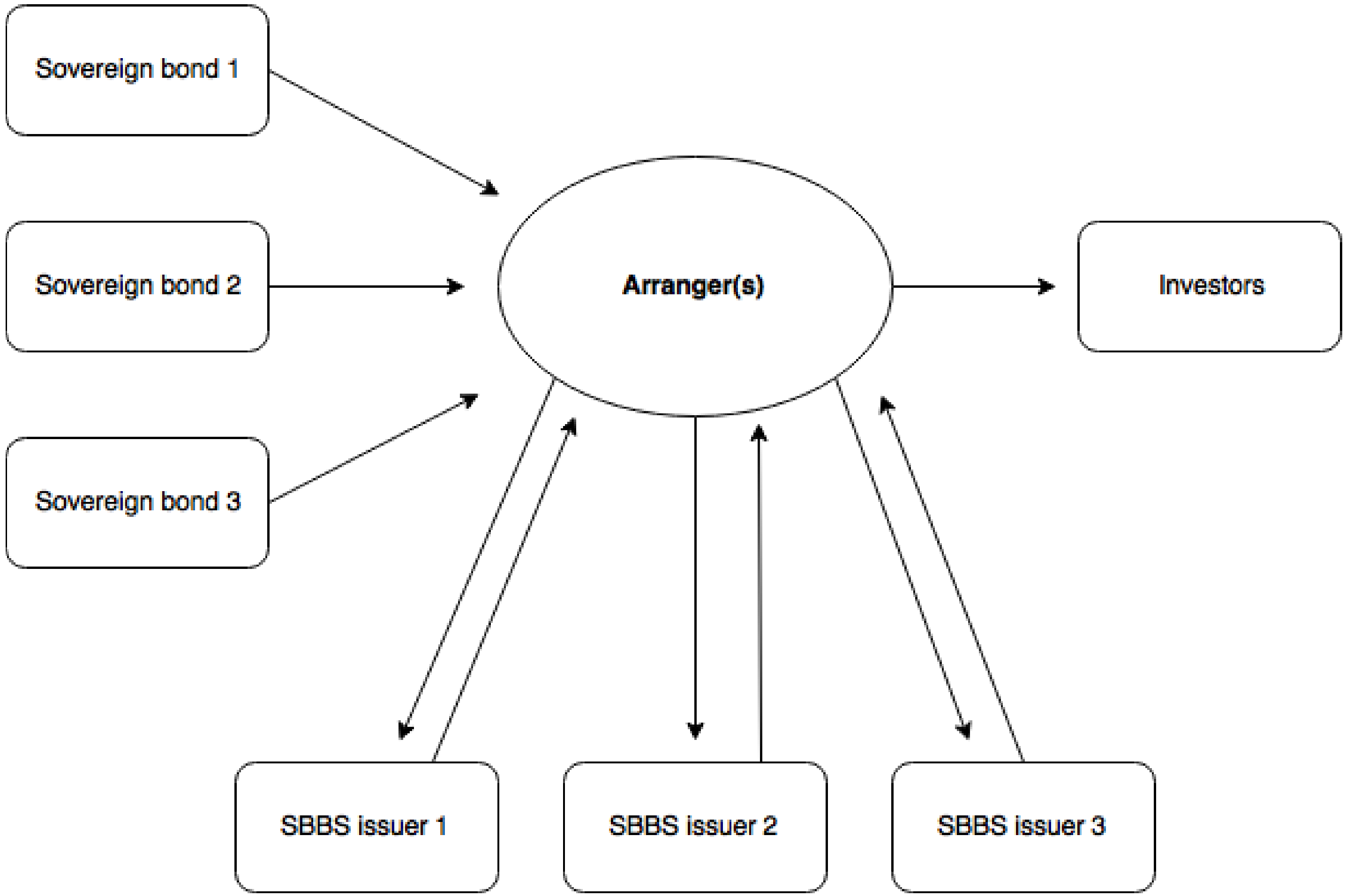
Risk properties of SBBS: insights from market data

Risk measure	Time period	Senior security (70%-thick)	Mezzanine security (20%-thick)	Junior security (10%-thick)
Historical simulation (long-term averages)				
Yield and EL	2000-16	(DE = s) < FI	BE < (IT = m = ES) < IE	PT << j << GR
1% VaR	2000-16	NL < (DE = s = AT) < FR	ES < (IT = m) << IE	IE < (PT = j) << GR
1% ES	2000-16	FI < (DE = s = AT) < FR	ES < (IT = m) << IE	IE < (PT = j) << GR
Historical simulation (crisis times)				
Yield and EL	2011-12	DE < s < FI	BE < (IT = m) < ES	PT << j << GR
Yield and EL	June 2012	DE < s < FI	BE < (IT = m) < ES	PT << j << GR
1% VaR	2011-12	DE < (FR = s = NL) << BE	ES < (IT = m) << PT	IT << (j = IE) << GR
1% ES	2011-12	DE < (FR = s = NL) << BE	ES < (IT = m) << PT	IT << (j = IE) << GR
1% VAR-for-VaR	June 2012	DE = s = NL	ES = m < PT	PT < j < GR
GARCH volatility	June 2012	DE = s = FI	PT < m < GR	PT < GR < j

How would SBBS be issued?

- **Each government still issues and services its own bonds**
  - SBBS arranger(s) buy conventional sovereign bonds at market prices
  - If a bond does not have a market price, it would not be included in the portfolio
- **SBBS arranger(s) could be private or public**
  - Private: Multiple arrangers to be regulated and supervised
  - Public: Single arranger would require institutional framework to preclude perception of joint guarantees
- **SBBS issuers are bankruptcy-remote pass-through entities**
  - Issuers bear no risk on their own account: they receive portfolio directly from SBBS arranger(s), and pass cash flows to SBBS investors according to seniority

Generic SBBS issuance model



Venue of purchases and institutional framework

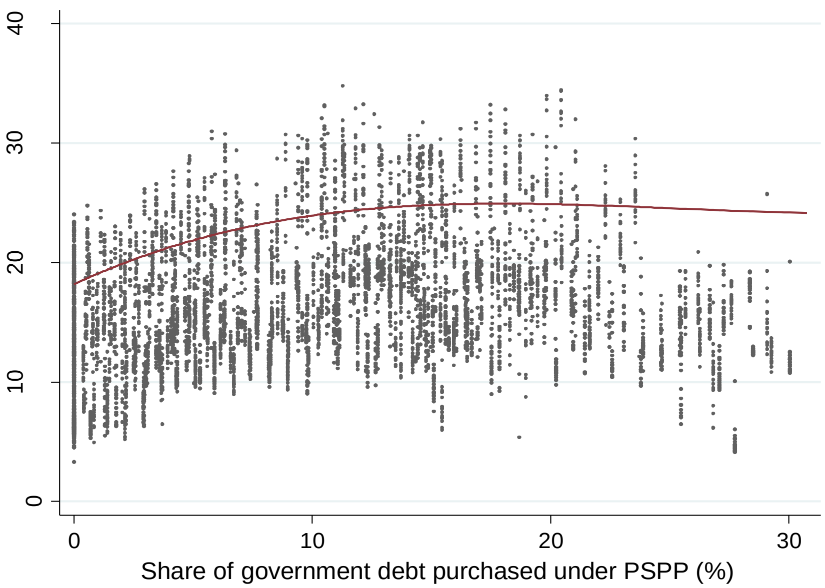
- **SBBS arranger(s) could assemble sovereign bonds on primary and/or secondary markets**
- **The choice of venue represents a potential trade-off**
  - Minimise changes in DMO issuance vs minimise warehousing by arranger(s)
  - To further reduce warehousing risk, arranger(s) could make use of an order book: investors submit orders before arranger(s) assemble the cover pool
- **The institutional framework can be designed to assuage concerns arising from potential warehousing of the underlying**
  - Private sector arrangement would exclude mutualisation from warehousing
  - Endowing a public sector arranger with fixed initial paid-in capital (similar to ESM on a much smaller scale) would prevent uncontrolled mutualisation

Incremental development of an SBBS market

- **SBBS issuance would be demand-led**
  - Issued only insofar as there is investor demand for the three securities
- **SBBS market would develop gradually**
  - Early phase: Similar to ESM bond market development
  - Transitional phase: Market grows gradually (e.g. to €1.5tn), conditional on smooth market functioning
- **Market size can be controlled by policymakers**
  - Unintended side-effects can be managed by rationing the issuance of “SBBS license numbers”
  - An issuer limit for SBBS could help to maintain market functioning and price formation in national sovereign bond markets (similar to PSPP)

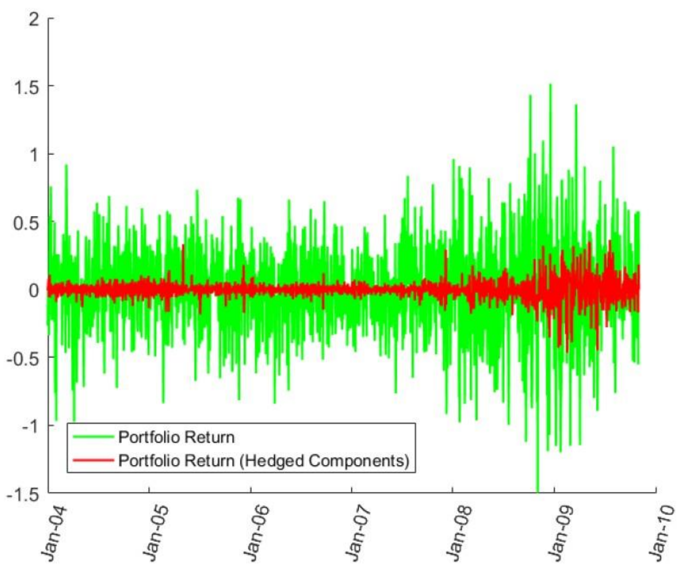
Ambiguous effects on sovereign bond market liquidity

Freezing effect (-ve):
Sovereign bonds frozen on SBBS issuers' balance sheets



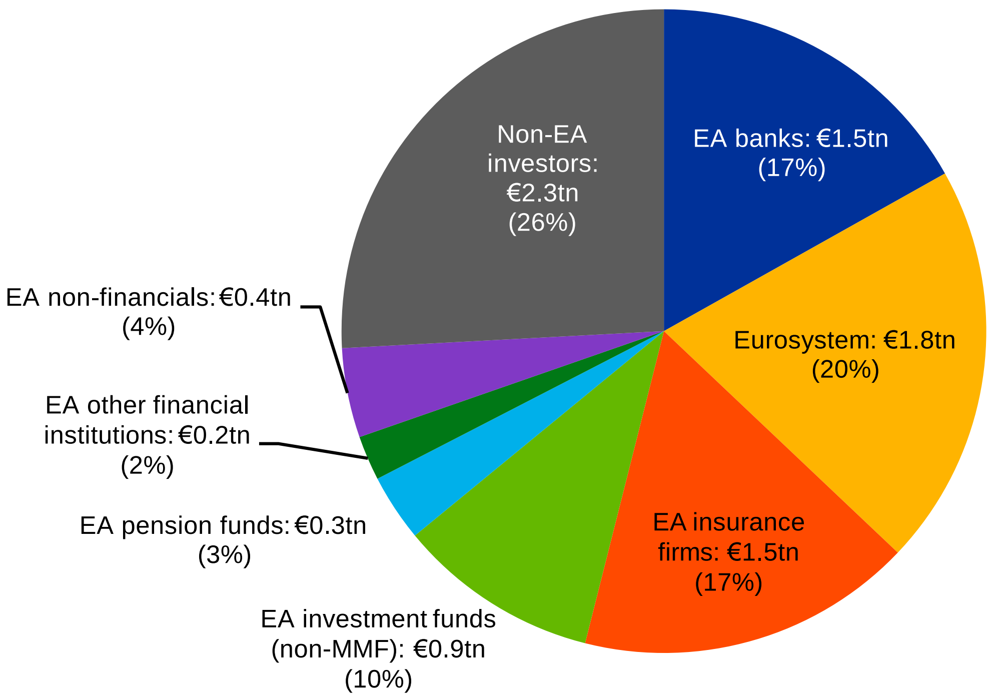
Spillover effect (+ve):
Liquid SBBS could be used to reduce hedging costs

(Hedge=Snr & Mezz)

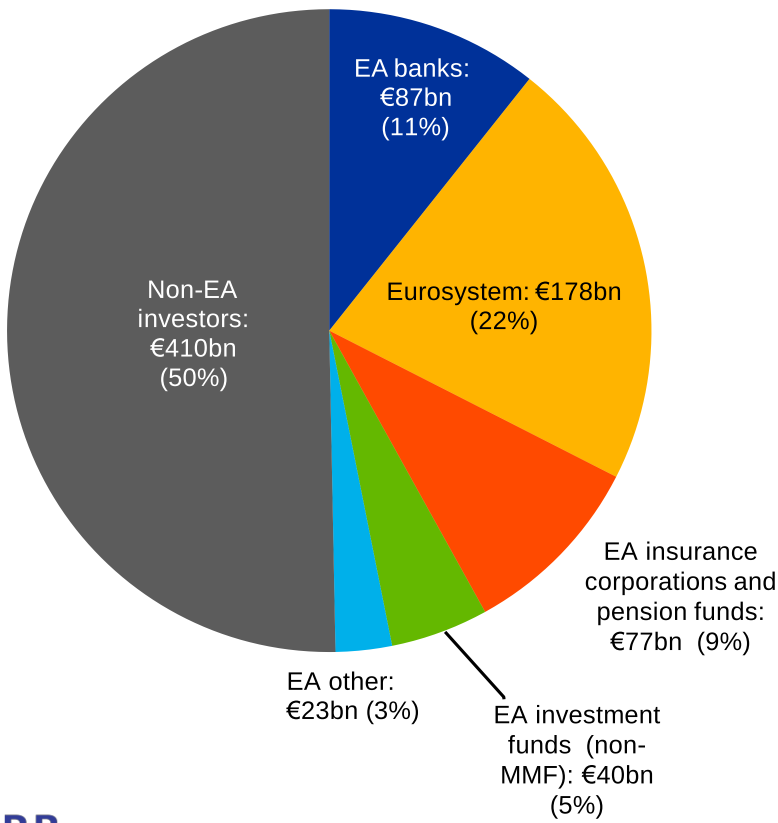


Investment-enhancing effect from non-euro investors

Holdings of government bonds

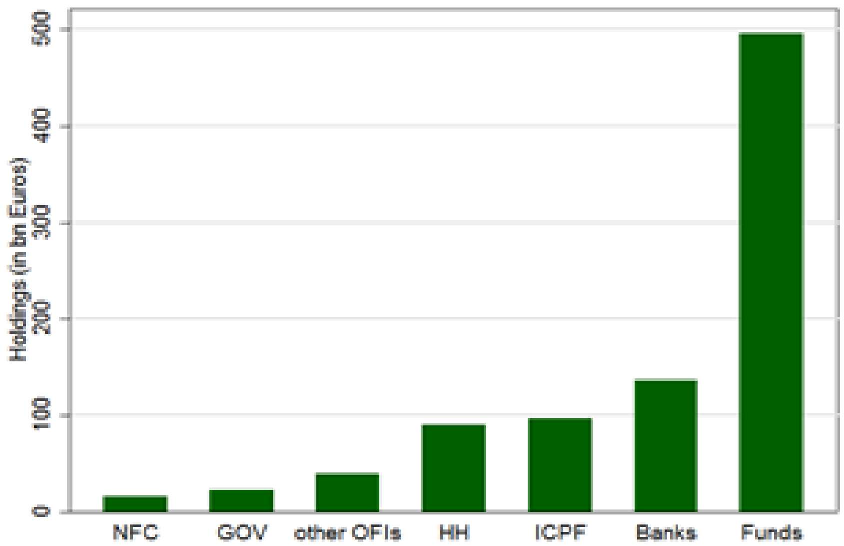


Holdings of supranational bonds



Which investors would buy junior SBBS?

Holdings of high yield debt securities



Demand for junior SBBS is an empirical question

- It could arise from investors seeking high returns
- Euro area investors currently hold more than €800bn in instruments with risk/return characteristics similar to junior SBBS
- Most of these investors are investment funds

- **What happens to junior SBBS during "risk-off" episodes?**
  - Price effect (yes): senior SBBS increase in value; junior SBBS fall in value *(see Volume II, Section 1)*
  - Volume effect (no): New SBBS would only contain bonds with a market-clearing price, so junior SBBS must also have a market-clearing price *(see Volume II, Section 2)*

Regulation: necessary to remove existing barriers

- **At present, SBBS receive unfavourable regulatory treatment**
  - Sufficient reason why the securities have not yet been created by markets
- **One necessary condition for market creation is to treat SBBS in line with their unique design and risk properties**
  - Senior SBBS: Analysis in Volume II suggests that they should be treated no more severely than sovereign bonds
  - Non-senior SBBS: Treatment should reflect their greater riskiness
- **An enabling SBBS-specific product regulation could remove existing barriers by providing a new treatment for all sectors**
- **RTSE reform would substantially enhance demand for SBBS**
  - However, this does not provide sufficient justification for RTSE reform, which should be evaluated on its own merits

Conclusion and next step

- SBBS represent one interesting and attractive option for the design of an area-wide low-risk asset
- Gradual development of a demand-led market for SBBS may be feasible under certain conditions (notably regulation)
- HLTF published its report on 29 January 2018 to inform policy discussions
- Next step: initiative from the EU Commission in Q2 2018
  - Commission launched an inception impact assessment on SBBS product regulation for interested parties to submit their feedback (closed 20 February)