ESRB
European Systemic Risk Board
European System of Financial Supervision

ESRB High-Level Task Force on Safe Assets

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Safe Assets: Some 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-level fiscal liabilties (no joint mutualisation)
- Doom loop between domestic banking system and domestic sovereign

Background to the creation of the ESRB HLTF on Safe Assets

- In June 2016, the ESRB GB established a HLTF
  "to further investigate the empirical and practical considerations" related to sovereign bond-backed securities (SBBS)
- SBBS represent an idea to create an area-wide low-risk asset without fiscal mutualisation
  - Securities would be created by pooling and tranching cross-border portfolios of national sovereign bonds
- Over past 18 months, HLTF has conducted analysis and gathered insights from market participants on feasibility of SBBS

HLTF's technical contribution sheds light on SBBS

- HLTF's contribution is technical: sheds light on unique properties of SBBS and their potential role in enhancing financial stability
- Two-volume report summarizes the HLTF's findings:
  - Volume I: 50 pages covers: motivation for SBBS; security design; market development; and regulation
  - Volume II: 250 pages covers: risk measurement; contractual features; market intelligence; market liquidity; and a more detailed analysis of regulation
- Report will be published shortly

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 with an SBBS-specific regulation that removes existing impediments

Regulatory Treatment of Sovereign Exposures (RTSE)

- HLTF has <u>not</u> attempted to assess RTSE options: the focus was on SBBS, not RTSE
- From the perspective of SBBS, it is clear that certain RTSE reform options would substantially enhance demand for the securities
- This finding does not provide sufficient justification for embarking on RTSE reform, which should be evaluated on its own merits in other policy fora
- The HLTF report acknowledges the differing policy positions of HLTF members with respect to RTSE

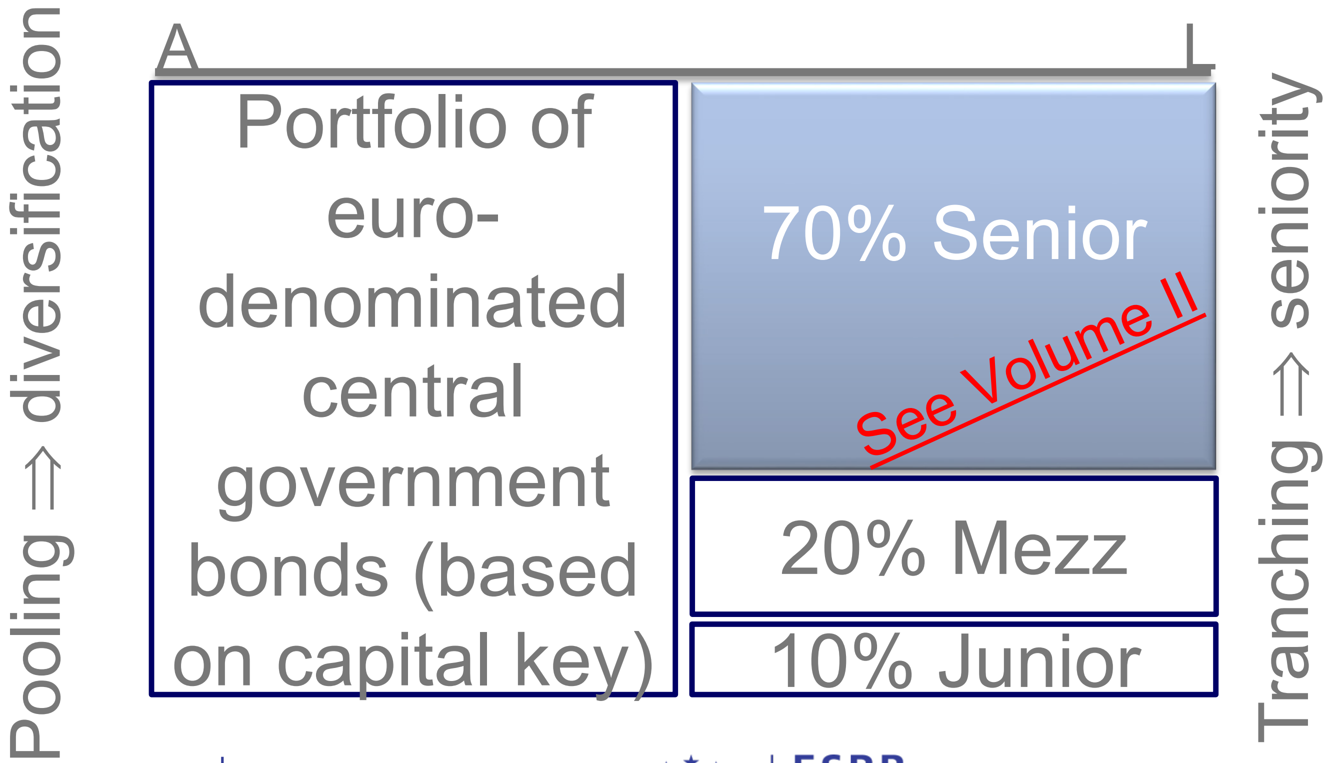
Motivation for SBBS: financial stability and integration

- **SBBS could contribute to financial stability by supporting efforts to complete banking and capital markets unions**
- **Reduce systemic risks by weakening the bank-sovereign nexus**
  - Combination of <u>diversification</u> and <u>de-risking</u> 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**

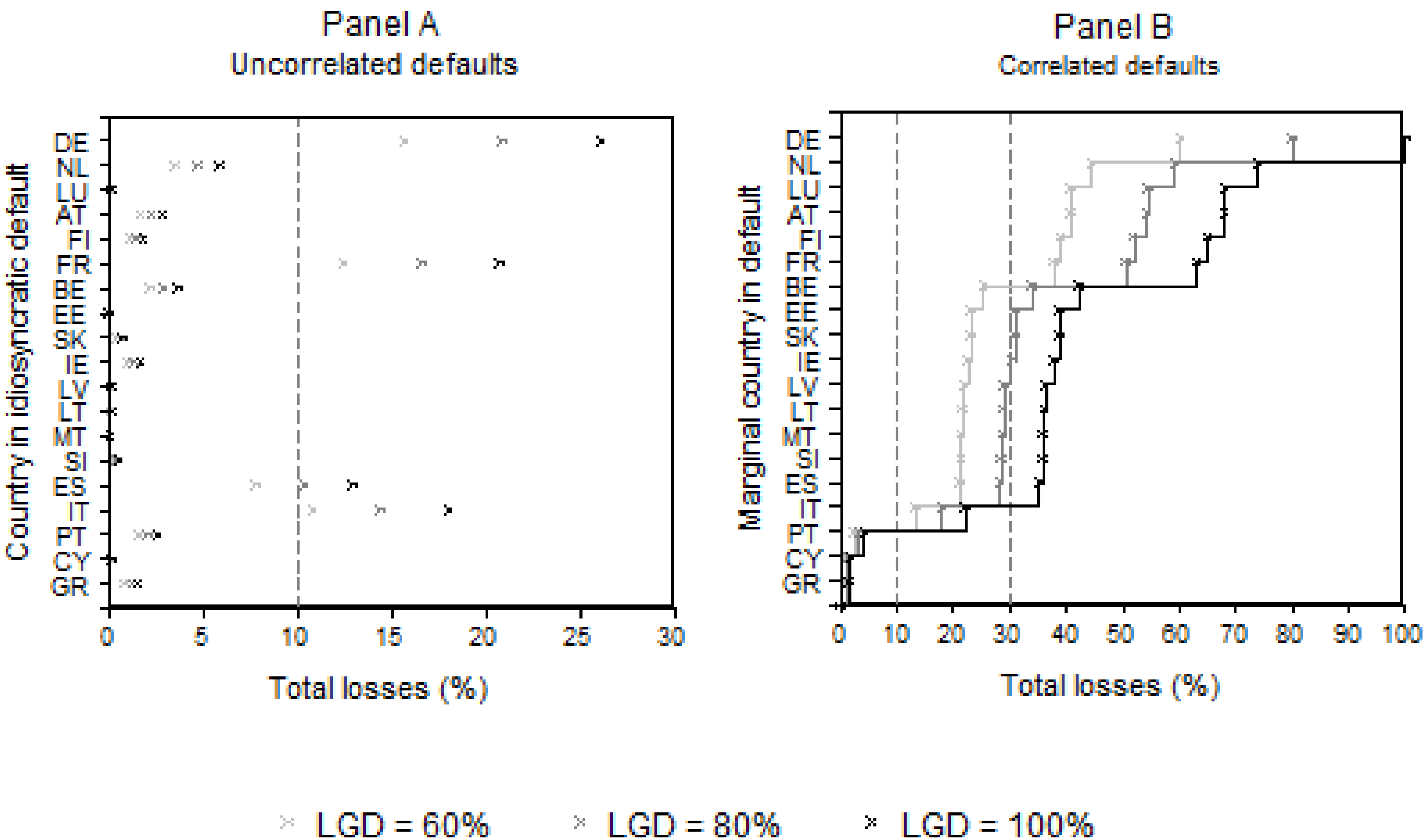
Basic security design reflects policy objectives

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



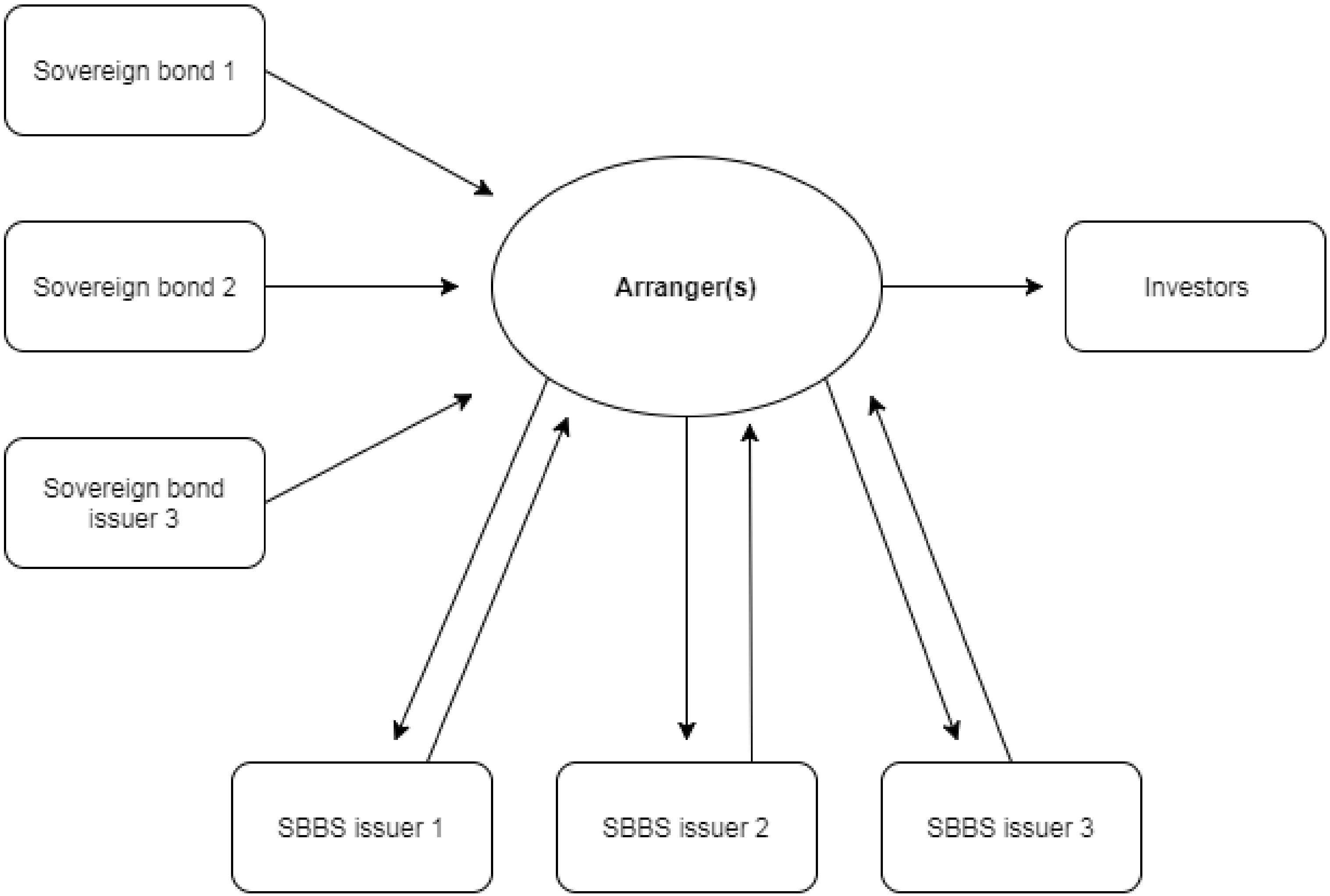
Risk properties of SBBS: insights from market data

Structure 70:20:10		Senior	Mezzanine	Junior
Historical simulation: Long-term averages:				
Estimated Yields and EL	2000-2016	(DE = **s**) < FI	BE < (IT = **m** = ES) < IE	PT << **j** << GR
Market 1%VaR	2000-2016	NL < (DE = **s** = AT) < (BE = FR)	ES < (IT = **m**) << IE	IE < (PT = **j**) << GR
Market 1%ES	2000-2016	FI < (DE = **s** = AT) < FR	ES < (IT = **m**) << IE	IE < (PT = **j**) << GR
Historical simulation: Crisis times:				
Estimated Yields and EL	2011-2012	DE < **s** < FI	BE < (IT = **m**) < ES	PT << **j** << GR
	June 2012	DE < **s** < FI	BE < (IT = **m**) < ES	PT << **j** << GR
Market 1%VaR	2011-2012	DE < (AT = FR = **s** = NL) << BE	ES < (IT = **m**) << PT	IT << (**j** = PT = IE) << GR
Market 1%ES	2011-2012	DE < (AT = FR = **s** = NL) << BE	ES < (IT = **m**) << PT	IT << (**j** = PT = IE) << GR
VAR-for-VaR 1%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 some sovereign bonds on primary or secondary markets 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 would need 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

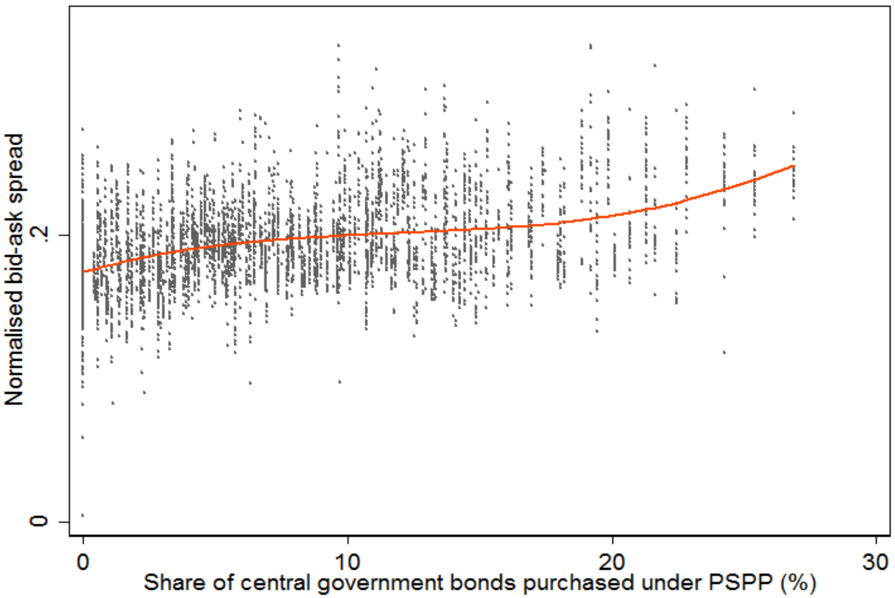


Incremental development of an SBBS market

- **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"

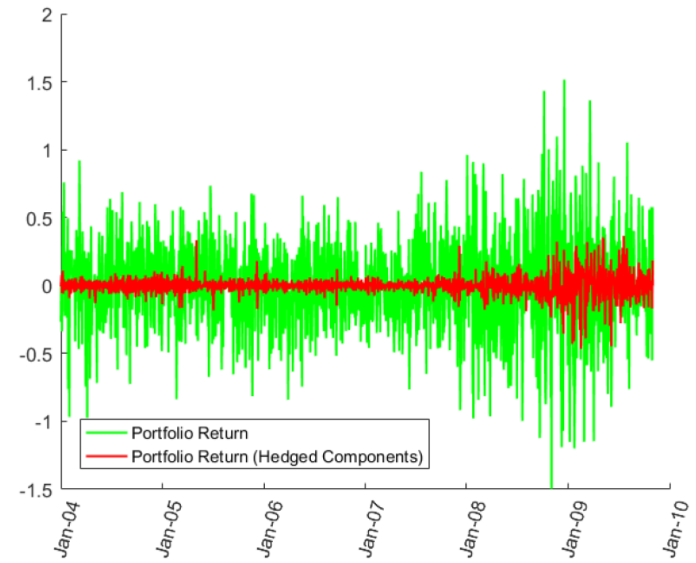
Ambiguous effects on sovereign bond market liquidity

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



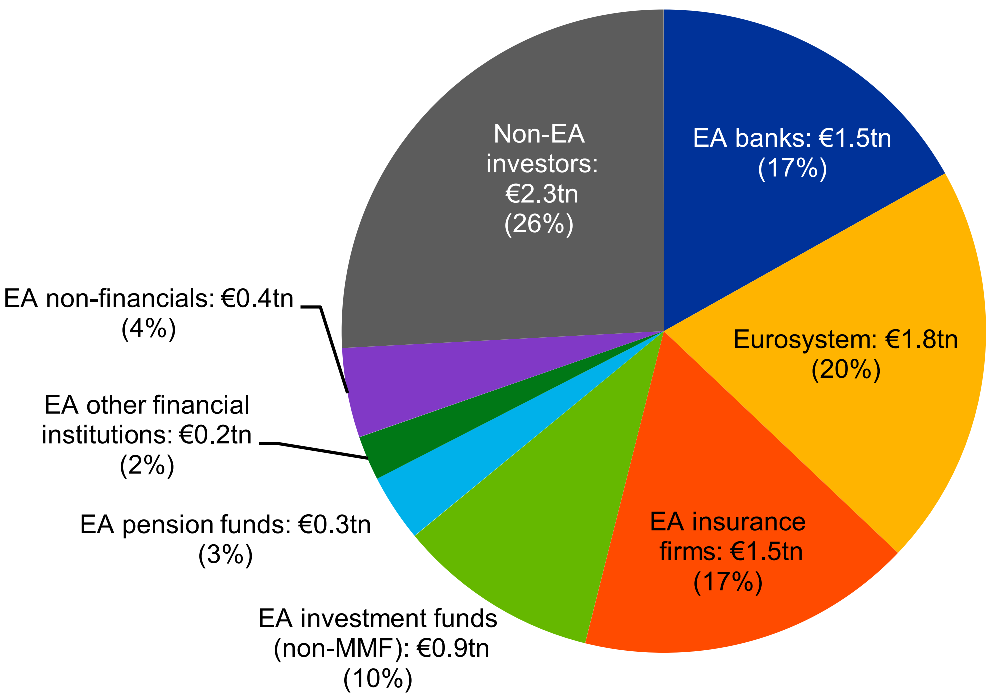
Spillover effect (+ve):
Liquid SBBS could be used to reduce hedging costs

(Hedge=Snr & Mezz)

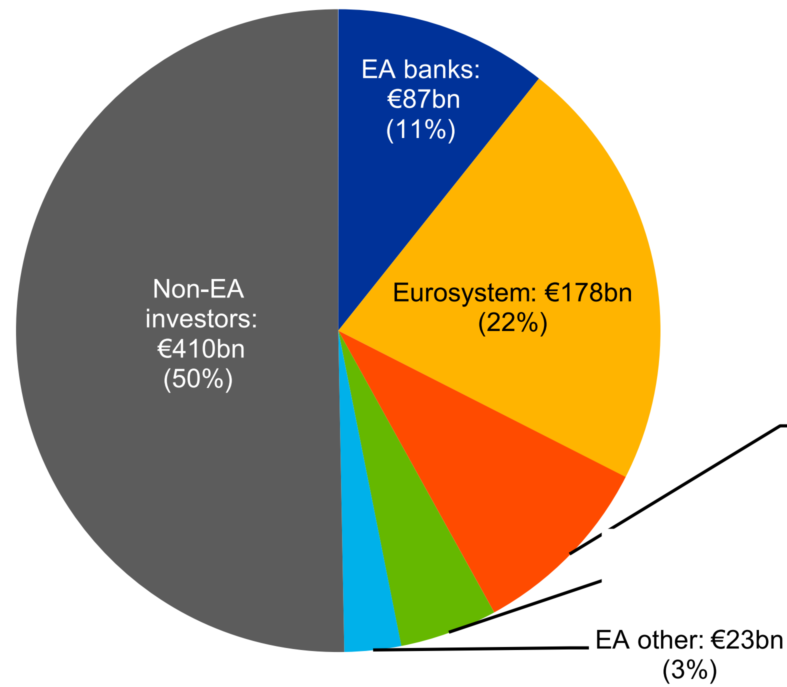


Investment-enhancing effect from non-euro investors

Holdings of government bonds



Holdings of supranational bonds



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**

Conclusion and next steps

- 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
- Necessary to remove regulatory barriers to market development
- Next step: publish report to better inform policy discussions
  - Past contributions from market participants are expected to be revised as report brings to light new information