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Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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BY EMAIL AND BY POST

Bríd Dunne
Clerk to the Joint Committee
Joint Committee on Finance, Public Expenditure and Reform, and Taoiseach
Leinster House
Dublin 2

15 November 2018

Re: Parliamentary Scrutiny of EU legislative Proposal

Dear Ms Dunne

I refer to your letter dated 27 September 2018 requesting the views of the Central Bank of Ireland ('the Central Bank') on EU Commission Proposal COM (2018) 339 – Proposal for a Regulation of the European Parliament and of the Council on sovereign bond-backed securities.

Background

The Central Bank contributed significantly to the work of the ESRB's High Level Task Force on Safe Assets (HLTFSA), which was chaired by myself. Membership of the Task Force included senior officials from many EU member countries; with the European Commission, ECB, ESRB, national central banks and regulators, the Economic and Financial Committee, EBA, and ESM, all playing active roles in the various work streams underpinning the report.

The report of the Task Force concluded that, while it is impossible to know in advance the full impact of SBBS, the analysis indicates its potential for a positive contribution to the financial stability and financial integration of the European system, with mitigants available to manage possible adverse side effects. It is also clear that an enabling piece of regulation is needed for an SBBS market to emerge.

The Central Bank is supportive of the findings of the analytical work of the Task Force, and welcome the European Commission's proposal for a regulation on SBBS, published in May 2018.

High-level overview of the benefits of SBBS

Financial stability would be enhanced by the creation of an asset class that reconciles the co-existence of a monetary union with national-level fiscal autonomy. By pooling and tranching GDP-weighted baskets of national sovereign bonds, an area-wide safe asset is created in the form of senior-level SBBS, while the exposure to sovereign risk is allocated to the holders of the mezzanine and junior tranches. This provides institutions and individuals that wish to hold a low-risk asset with an expanded supply in the form of senior-level SBBS, while exposure to sovereign risk is allocated to the more risk-tolerant investor types that would hold the mezzanine and junior tranches.

The existence of senior SBBS would facilitate banks to hold a more diversified and de-risked exposure to sovereign debt. For smaller banks in particular, trying to replicate such portfolios would be prohibitively costly, and of course, would still not have the same risk nature as senior SBBS, which have the protection of the sub-tranches. Financial stability and financial integration would be enhanced by the presence of SBBS, while fully respecting the principle of 'no debt mutualisation', which is a key tenet of the product design. SBBS could generate significant demand from global investors, which for a small issuer like Ireland, could enlarge the base of end-investors, and tap investors that we do not have the scale to tap under the status quo.

A fundamental design feature of SBBS is that the product involves no debt mutualisation – each government remains responsible for its national debt. The Task Force report goes into extensive detail in relation to the steps that can be taken to limit the risk of ex-post mutualisation. In particular, SBBS would be issued via legal structures that are designed to rule out any temptation to intervene in the SBBS mechanism during crisis periods.

Financial integration would be enhanced, since the euro area would have an area-wide low-risk asset that could emerge as the natural benchmark for asset pricing and collateralised transactions. Moreover, during periods of stress, "flights to safety" would not have a cross-border dimension but would rather take the form of shifts in demand between the riskier and senior tranches. The role of SBBS in fostering integration means that it could be an important element in building the capital markets union (CMU).

The need for an enabling regulation

An enabling regulatory framework would be required in order to facilitate the issuance of SBBS. In particular, SBBS is a unique product category in that the underlying assets (national sovereign bonds) cannot be compared to the assets that are bundled in typical securitisation vehicles. The European Commission (hereafter 'Commission') noted that, "Under the existing legal framework, SBBSs would be treated as securitisations and thus be subject to additional charges and discounts relative to the charges and discounts faced by the euro area sovereign bonds in the underlying portfolio. Those additional charges and discounts would hinder the production and use of SBBSs by the private sector, despite the fact that SBBSs do not carry the risks associated with securitisations that justify such charges and discounts." In May 2018, the Commission published their regulatory proposal.

Key elements of the Commission's proposed regulation – a Central Bank perspective

1. *Public versus Private SBBS issuer*

The Task Force report had left open the question as to whether the issuance of SBBS should be a public or private initiative, but set out the case for either model. An important point of clarity, which the proposed regulatory framework has provided, is the fact that only a market based issuance approach is to be adopted[1]. The Central Bank acknowledges that a market led approach results in minimal financial or reputational risks for the European institutions, and allows the market to determine whether the product should exist. Importantly, the absence of public sector involvement in the issuance process should provide sufficient appeasement to those that are sceptical about the level of investor demand, and allay concerns that SBBS could be perceived as a vehicle for risk sharing or fiscal mutualisation between Member States.

2. *Regulatory treatment of the tranches*

The Task Force acknowledged very clearly the relative riskiness of the tranches, and the expectation for differentiated risk treatment. The Commission, however, find that on balance, levelling the regulatory playing field for all tranches maximises the enabling nature of the proposed product legislation. The argument for equal regulatory treatment across all tranches is understandable given that all of the underlying sovereign bonds receive zero-risk weightings, when it comes to capital requirements for banks. However, it is somewhat unintuitive to provide the same risk treatment across senior, mezzanine, and junior tranches given the *a priori* differences in the relative riskiness of the tranches.

3. *The tranching structure*

Allowing the market to determine the tranching structure of the sub-senior tranches is a novel approach that differs from the Task Force's recommendation for a defined 70/20/10 senior/mezzanine/junior split. On the one hand, it has the potential to create less homogeneity between the tranches, and as a consequence, this would adversely impact on liquidity. On the other hand, the success of the product is predicated first-and-foremost on the ability to issue the junior tranche. Designing the sub-senior tranching structure in a market friendly manner, offers the overall structure the best chance of success, without changing the risk profile of the senior tranche. In any event, we would expect a market equilibrium to emerge over time, which would address some of the homogeneity concerns.

[1] While the SBBS is backed by a pool of euro area sovereign bonds, the issuer of the SBBS would be a private entity, rather than a public body.

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Sovereign Issuer Concerns

The main concern in relation to the introduction of SBBS is that it could disrupt the operation of the markets for national sovereign bonds. While the euro area debt management offices (DMOs) expressed a range of concerns, the Central Bank believes that these concerns can be largely addressed as operational issues, rather than classified as core concerns in relation to the net desirability of SBBS as an asset category. Importantly, regulators could limit the risk of disruption to national markets by setting quota limits on SBBS issuance as a transitional matter. In its impact assessment of the proposed regulation, the Commission assessed the effects of SBBS under two scenarios: a world in which SBBS reached only a limited volume (€100 billion) and one where SBBS grew to a steady-state size of €1.5 trillion. It is worth nothing that even the larger steady-state SBBS size, would represent less than 20% of the overall euro area sovereign debt market.

Summary

The availability of the senior tranche of SBBS would facilitate banks to hold a more diversified and de-risked exposure to sovereign debt. Since SBBS are manufactured by combining the bonds of all member countries (with market access), the privilege of issuing 'safe' debt (the senior tranche) is shared by all members. During periods of elevated risk, the doom loop between banks and sovereigns would be attenuated if banks held senior-level SBBS rather than national bonds. Importantly, the Commission found that if the larger SBBS size were achieved, its impact on the diversification of banks' sovereign bond portfolios could be significant. They find that the 'home bias' for euro area banks' sovereign portfolios (in its sample of euro area banks covered by the European Banking Authority's transparency exercise) would be reduced by 42%.

Demand for SBBS would be substantially enlarged under various reforms that moved away from the current regulatory treatment of sovereign bonds. Still, even under current regulations (assuming the enabling framework is implemented), the demand for SBBS could be significant, including from non-banks and global investors.

Ultimately, the primary consideration in relation to SBBS is the "do no harm" principle: it is difficult to sustain hypotheses that postulate that the addition of an extra asset category (SBBS) would make the European financial system more unstable or less integrated. Given the potential of SBBS to generate significant gains for the European system, without generating significant intrinsic downside risks, the enabling regulation framework for SBBS should be supported. After that, the existence and size of the SBBS market will be determined by the level of investor demand.

Yours sincerely

Philip Lane