



ESRB

European Systemic Risk Board

European System of Financial Supervision

ESRB High-Level Task Force on Safe Assets

Philip Lane (Chair)

Sam Langfield (Secretary)

Spyros Alogoskoufis (Assistant Secretary)

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 liabilities (no joint mutualisation)
- Doom loop between domestic banking system and domestic sovereign



ESRB

European Systemic Risk Board

European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED

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



ESRB

European Systemic Risk Board

European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED

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



ESRB

European Systemic Risk Board

European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED

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



ESRB

European Systemic Risk Board

European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED

Regulatory Treatment of Sovereign Exposures (RTSE)

- HLTF has not 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



ESRB

European Systemic Risk Board

European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED

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 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

European Systemic Risk Board

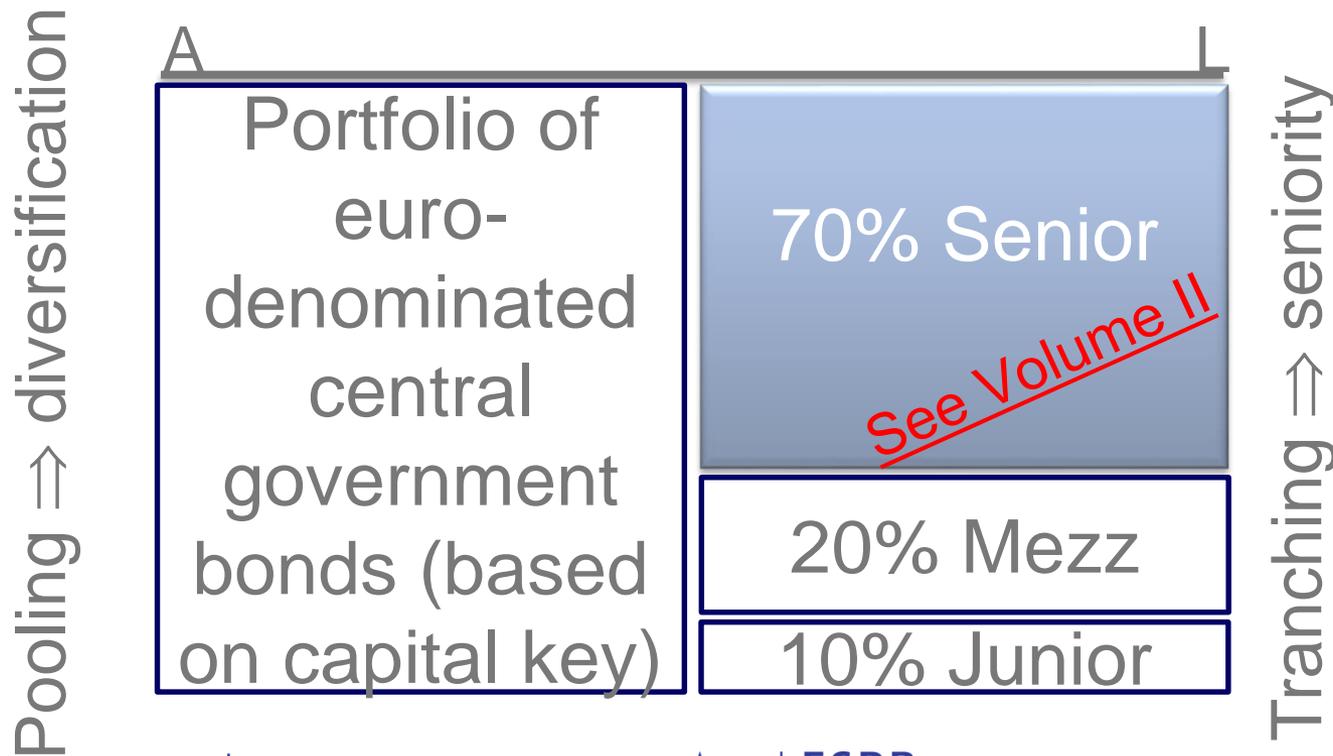
European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED

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)



ESRB

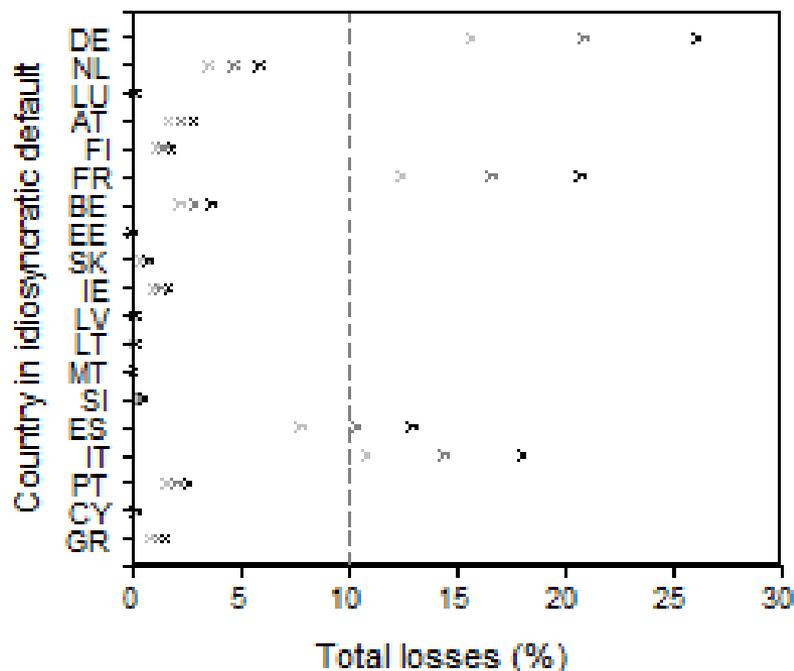
European Systemic Risk Board

European System of Financial Supervision

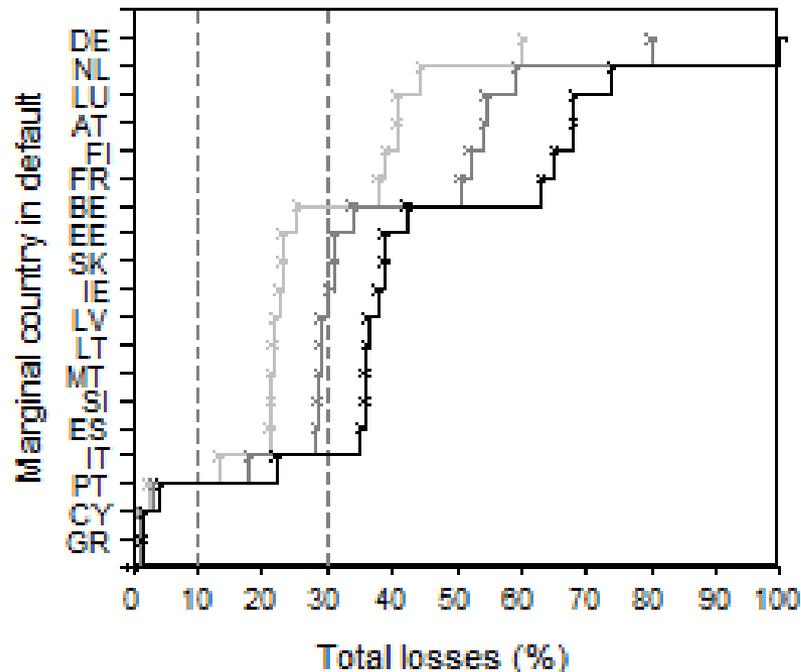
Central Bank of Ireland - UNRESTRICTED

Risk properties of SBBS: insights from default simulations

Panel A
Uncorrelated defaults



Panel B
Correlated defaults



× LGD = 60%

○ LGD = 80%

× LGD = 100%



ESRB

European Systemic Risk Board

European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED

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



ESRB

European Systemic Risk Board

European System of Financial Supervision

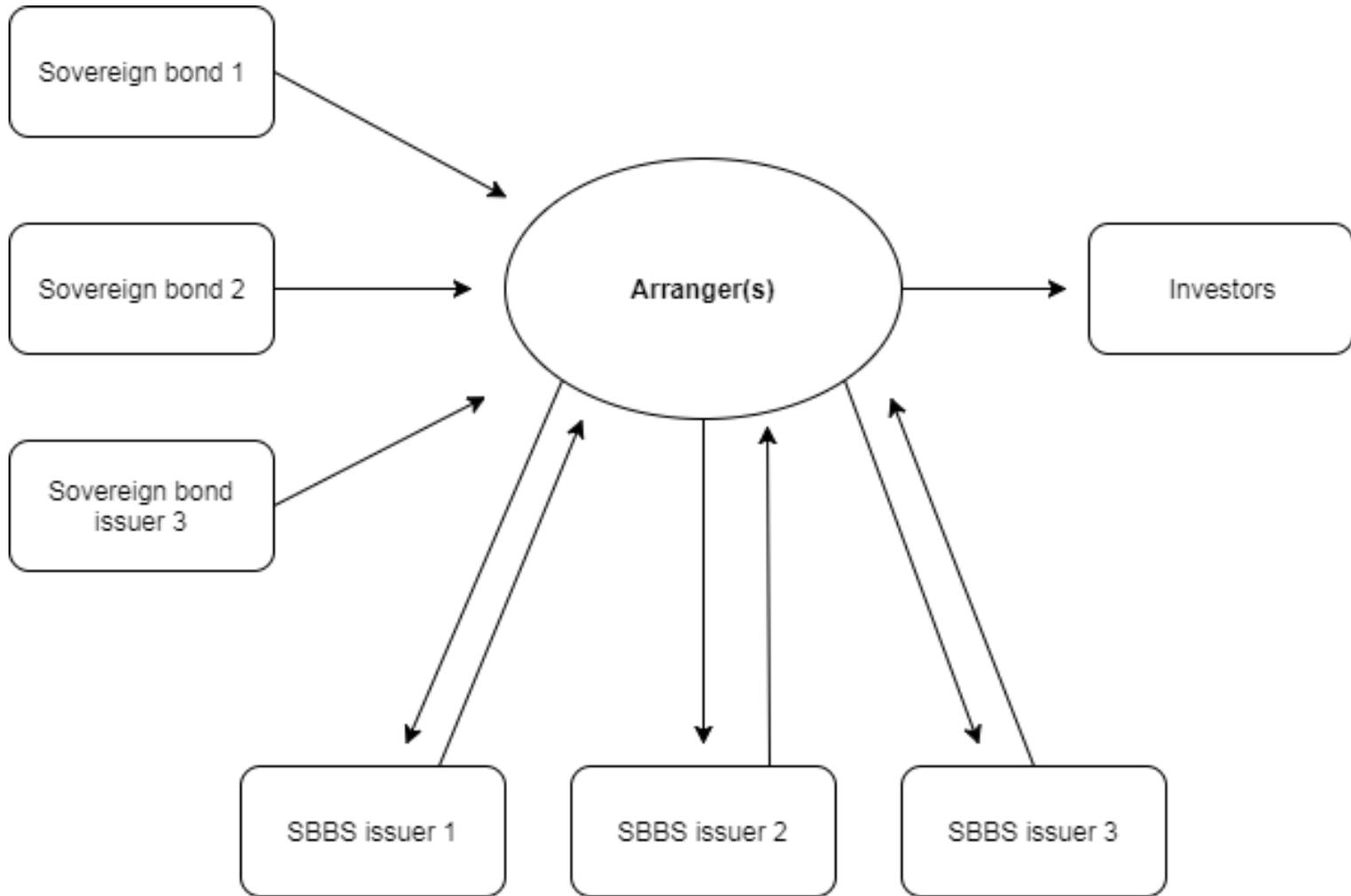
Central Bank of Ireland - UNRESTRICTED

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”



ESRB

European Systemic Risk Board

European System of Financial Supervision

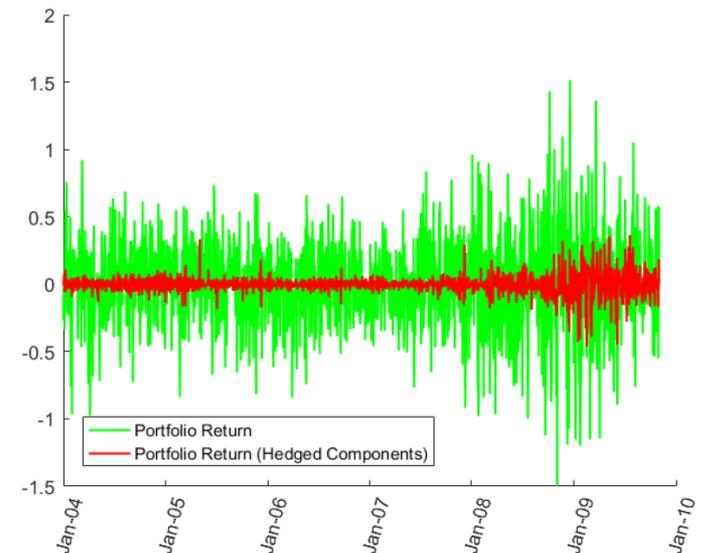
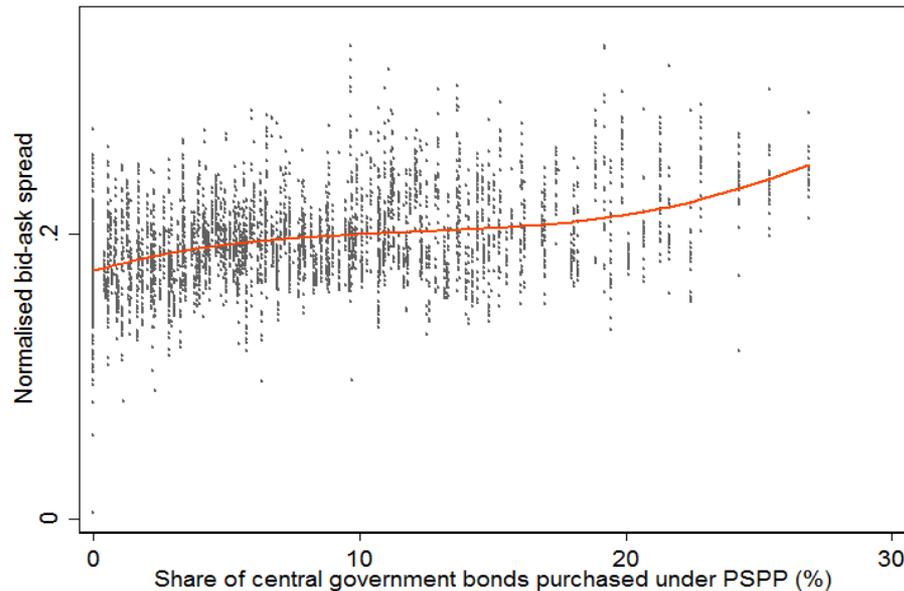
Central Bank of Ireland - UNRESTRICTED

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)



ESRB

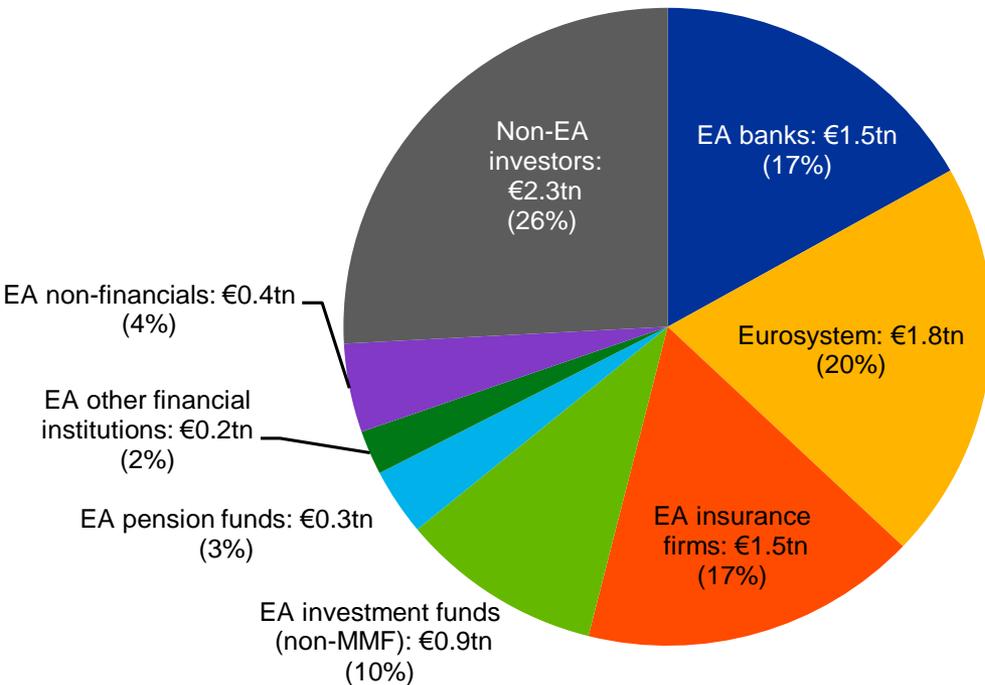
European Systemic Risk Board

European System of Financial Supervision

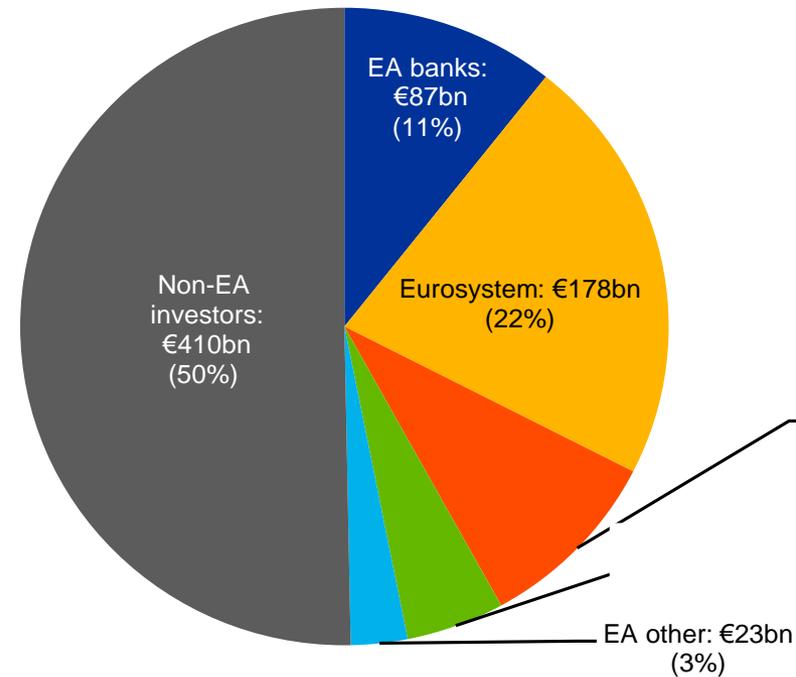
Central Bank of Ireland - UNRESTRICTED

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**



ESRB

European Systemic Risk Board

European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED

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



ESRB

European Systemic Risk Board

European System of Financial Supervision

Central Bank of Ireland - UNRESTRICTED