European Sovereign Bond-Backed Securities – a Proposal to Mitigate Risks Arisen from the Lack of an Euro Area Common Fiscal Policy

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Abstract

"European Sovereign Bond-Backed Securities" explores the complexities of having a fiscal union for Euro Area. All measures taken for fiscal integration are elements that need cohesion in order to break the vicious circle of unsustainable public debt affecting the balance sheets of banks and deepening the need for rescue, which signals a further deterioration in asset valuation and markets shrinking, worsening further the economic conditions. The need for a synthetic bond obtained by securitization of Euro Area governments' debts emerges as viable proposal to break this public debt – private debt circle. Furthermore, it explores the "impossible trinity" (Mundell-Flemming) and the translation into the Euro Area. The conclusions point to the need for institutionalized and official approach of introducing such derivative products like European Sovereign Bond-Backed Securities in the quest for safe assets, aiming to break the circle of debt (effect) by substituting the absence of a common fiscal policy (cause).

Key words: European Safe Bonds, Sovereign Bond Backed Securities, Fiscal Policy, Trilemma, Synthetic Eurobonds
J.E.L. Classification: E44, E60, E62, F32, F33, F34, F36, F45, G01, G15, G21, G28, H63, H81

1. Introduction – The need for a deeper fiscal frame

The onset of the financial crisis and its development in Europe in waves of shocks exposed weaknesses in the financial system in Euro Area and critical failures in its core structure, triggering malfunctions in the Economic and Monetary Union (De Grauwe, 2013). The original idea in the Werner Report (Council, Commission, 1970, p.10) was centered on a monetary union and a budget policy and resources centrally administered. MacDougall Report (Commission, 1977, vol.1) presented the first view on the role of public finance in European integration, stating that a budget of 2.0% – 2.5% during transition phase and 5.0% – 7.0% after the integration the long-term objective being "a Federation in Europe in which federal public expenditure is around 20-25 percent of gross product as in the USA and the Federal Republic of Germany" (Commission of the European Communities, 1977, p.10-11). The budget would be deemed mandatory to smooth macroeconomic disequilibria and ensure a minimum convergence of incomes. But France rejected the idea of a European Communities Common Budget and dismissed the Werner Report. These reports did not rally political support. Therefore, the Delors Report (Committee for the study of Economic and Monetary Union, 1989) approached and laid out the guidelines for a monetary union, advancing the idea that political desire to deepen the integrative process to fiscal level would follow a strong economic and monetary integration. The common budget remained all this time up to today at around 1% of Gross Domestic Product.

Next step occurred in 1992, when the Maastricht Treaty enforced national fiscal discipline by setting out limits for indebtness on short term (fiscal budgetary deficit not to exceed 3% of GDP) and on medium to long term (public debt not to exceed 60% of GDP) leading the way to the Stability and Growth Pact and to the most important additions: the six-pack in 2011 and the two-pack and fiscal compact in 2013 (Commission, 2017). At Maastricht, the core idea was that the monetary convergence preparing the adoption of the common currency, would need complementarities from

national fiscal policies adopting flexible fiscal measures to compensate and accommodate asymmetric shocks in the economies (Thirion, 2016). Financial and commercial integration would result in convergent business cycles that would help it evolve into an Optimal Currency Area (Frankel and Rose, 1998). The monetarist view (Friedman, 1963) pushed the idea price stability (manifested by inflation as phenomenon of quantity of money) would prevent highly speculative asset bubbles to form (as opposed to Keynesian theory to use fiscal policy measures to correct negative economic situations with the support of public spending from the budget). This monetary view is seen in ECB's mandate or statutory documents to ensure stability of prices by targeting inflation (ECB, 2017). The effect of financial, monetary and commercial integration has been a better synchronicity of economic cycles in Euro Area but that did not resulted in smoothly absorbed asymmetry.

The freedom of movement of the workforce is still at low levels, while the differential in prices and salaries has expanded regional disparities and lead to macroeconomic imbalances. To combat disparities and to attract flows of investing capital, fiscal policies in peripheral countries have been pro-cyclical instead of anti-cyclical, accumulating debt that has been financed by issuance of government debt by State Treasury (The Finance Ministry). Since banks financed the selling of those instruments because they have all the incentives to keep adequate liquidity and capital adequacy ratios (Bank of International settlements, Basel Committee on Banking Supervision, 2011, 2013, 2014), their balance sheets fully loaded with such assets deemed safe, treated by Basel as 0% risk weight for nationals. When those marked-to-market instruments fluctuated, banks became distressed and needed rescue.

The absence of a Fiscal Union in Euro Area is a concern for the European Commission. Under the listing of "achievements" it presents: the process (European Semester), the laws or governance rules (six-pack 2011, two-pack 2013, the Fiscal Treaty on Stability, Coordination and Governance in 2012), the debates over instruments (green paper on Stability Bonds in 2011) and the interventional tools (European Financial Stability Fund / European Stability Mechanism), so there are elements of a fiscal union (ECB, 2017).

A fiscal union "can be defined, in very broad terms, as transfer of part of fiscal resources and competences in the area of fiscal policy and fiscal management from the national to supranational level" (Dabrowski, 2015, p.7). Researchers and decision factors, independently or under institutional supervision, issued recommendations of various ways to develop this envisaged fiscal union: European unemployment (re-)insurance scheme for large shocks and automatic stabilizers (Benassy-Quere, Ragot and Wolff, 2016), correction of architectural weaknesses in the system to reduce the incidence and severity of future crises and provide long-term credibility to the crisis measures (Allard et al., 2013), the need for better sharing of the residual risk as wide range of risk exposure across countries is harmful to a monetary union (Cottarelli, 2012). The Five Presidents Report talks about an Integrated Framework for Sound and Integrated Fiscal Policies (Juncker, 2015, p.13) and of an Advisory European Fiscal Board (Juncker, 2015, p.23).

European discussions so far for a fiscal union resort to four main topics: crisis resolution mechanisms, rules coordination and risk reduction, common debt issuance, fiscal insurance and stabilization funds (Thirion, 2016, p.9). A special proposal has been made in 2011, regarding common debt issuance, to be discussed further, in the light of desired shared sovereignty / shared risks. The actual need is to simplify public finances in Euro Area countries and to clean balance sheets of commercial banks, by reflecting the correct exposures to risks.

2. The "diabolic loop", the "flight to safety" and the proposal of "Euro Safe Bonds"

The proposal of "Euro Safe Bonds" and the term "diabolic loop" has been coined by Euronomics Group in 2011 (updated in April 2012, revisited by Marco Pagano in 2016 and by Euronomics representatives in 2016 hosted by ESRB working papers series). The "diabolic loop" is facilitated by regulation. To ensure capital adequacy, commercial banks have a preference to store value in assets deemed "safe" and Basel Agreement states that government issued bonds are risk-free with 0% risk weight in banks' balance sheets, for the country of the bank. Analyzing the early stage of the financial crisis onset (2007-2009), commercial banks set up conduits to securitize assets while insuring the newly securitized assets using credit guarantees designed to reduce bank capital

requirements under Basel Agreement and transposed in legislation by EU under Commission's Capital Requirements Directive and subsequently by every country (Acharya, 2010).Therefore, banks keep a significant portion of portfolios in government bonds, not taking into account the differential in national fiscal systems.

Markets, however, price the risk of governments defaulting on their issued bonds, under the form of "Credit Default Swaps" which can be regarded as the cost of insurance to exchange the debt for money, in tranches of 10 Mil. USD, as basis points (1%=100bps). According to country ratings given by renowned institutions such as Moody's, Fitch, or Standard & Poors, reflecting the stability of the country, the cost of its debt varies over time and across regions and countries. For instance, on May 4, 2017, Greece's 5 years CDS is 672.005 bps while Italy's 5 years CDS is 160.755 bps (CNBC, 2017). Both countries are in Euro Area, but markets perceive the risks differently regarding the default risk over sovereign bonds issued on 5 year term: 6.72% versus 1.61%, a difference of 5.11%. This differential of risk of default is not reflected in banks' balance sheets according to accounting methodology of Basel Agreement.

When investors fear the risk of default on government bonds due to uncertainty of realizing future incomes as source for repayment (for instance, because the sources for budget income are decreasing, collection of taxes does not occur appropriately, or the national value in an economy usually Gross Domestic Product is decreasing, etc), they start to sell so the price drops to sell government bonds. When prices drop, yields increase and thus, the cost of refinancing increases for state and banks alike. Bank balance sheet is revalued at the new lower prices and banks start to sell assets to return to the levels of required capitalization adequacy (Adrian and Shin, 2014). These fresh sales of assets on the market push all prices down further, in combination with limitations on new lending. The economy suffers and GDP decreases, pushing higher the cost of default risk. When banks of systemic importance face the risk of illiquidity, insolvency or even bankruptcy, the state intervenes to recapitalize banks, by issuing more debt, bailing in or bailing out the financial institutions, to prevent contagion risk to other banks. This proves investors they were right to expect the initial increase in the risk of default and the loop starts again. It is a vicious circle, or rather a spiral unfolding, self-fuelling on public and privately held debt.

Euro Area banks have 1900 billion EUR on sovereign bonds (Brunnermeier et al, 2016, p.3) and are subject to European Central Bank supervision. Art. 123 of the Lisbon Treaty forbids to any of the Eurosystem's central banks to lend to public authorities or to buy bonds directly from them. Euro sovereign bonds are in reality not 100% safe and the sovereignty rights are "sub-sovereign" (Goodhart, 2013) and are issued in a currency that is above national control via monetary policy (Grauwe, 2013). The effect in the end is an increasing sovereign default risk, a deteriorating banking system and a decreasing macroeconomic activity.

The "diabolic loop" in which banks and governments are inter-locked in a financial trap is doubled by another phenomenon: in deteriorating economic environments, the investments are withdrawn and the capital "flights for safety", which accentuates the financial distress of public finances and private banks. To exit from such spiral, a change is needed and economists proposed various solutions. One of them seems to be the most adequate: "Euro Safe Bonds" (Euronomics, 2011, revisited up to 2016). In short, ESB is a synthetic bond obtained as a derivative via securitization of government bonds asset classes and tranching is essential. The principle is the following: based on a pool of government bonds, the senior tranche is "Euro Safe Bonds" with calculated risk of 0% weight and the junior tranche "Euro Junior Bonds" as risky assets that would bear the loss, but would have the highest potential of gain. The pooling of national bonds would be done by allocation according to country's weight of GDP in Euro Area's total GDP.

In this structure, ESB would ensure the safety of capital and EJB would benefit from coupons and expected higher yield on a smaller portion of initial capital and take the full impact of default risk. The Euronomics propose an independent agency to be created European Debt Agency (EDA) that would assume the process of securitization, marketing the instruments and taking charge of legislation. Countries would not have any joint responsibility. Relevant scenarios are taken into account (status quo, national tranching, pure pooling and pooling and tranching) in 3 models (severe recession with 5% probability, mild recession 25% and expansion 70% according to NBER surveillance on business cycles from 1854 to 2010), indicating that a cut-off at 70% ESB and 30% EJB would ensure AAA-rating for ESB. They would require no changes in the European Treaties

and could become an instrument of monetary policy for ECB as well as an instrument of reserve, and would be Basel-compliant (Brunnermeier et al, 2016, p.9&17).

In Europe, only Germany, Netherlands and Luxembourg have AAA rating. Deutsche Bunds represented in 2015 only 25% of Euro Area GDP compared to 105% US treasuries in USA GDP. The need for safe assets is evident in Europe and ESB with EJB cut-off at 30% would generate 4200 billion EUR of safe assets in Europe (Brunnermeier et al, 2016).

What ESB and EJB do not achieve is to resolve the problems of low economic growth, lack of economic competitiveness and productivity, or to ensure enhancement in public finances and execution of fiscal policy. They address the effect, not the root causes. In stress tests of Euro Area banks, those with higher exposure to sovereign default risk saw increases in insolvency risk a decrease in new loans and a rise in non-performing loans (Altavilla, Pagano, Simonelli, 2016).

3. The "trilemma"

Unofficially, the ECB is also interested in this subject matter, as a senior adviser, under the disclaimer that the views presented are personal and do not represent the views of the ECB, approached this topic under the title "Addressing the safety trilemma: a safe sovereign asset for the Eurozone" at CASE 25th Anniversary Conference in Warsaw in November 2016 and published under ESRB in March, 2015. In short, after 25 years since Maastrich Treaty, a missing piece of the European Monetary Union is a single safe asset, as EMU assets are sub-safe, sovereign bonds proved risky in real conditions outside Basel Agreement, the Euro Area is confronted with a safety trilemma (as per Mundell-Flemming model) and a differential in sovereign bonds, moral hazard and proposal of synthetic bonds as securitization of national sovereign government bonds.

To support trust in the safety of sovereign bonds, EU took legal measures and ECB supported the markets by interventions, such as: reinforcing fiscal discipline (6 pack, 2 pack, Fiscal compact), the introduction of European Semester and the macroeconomic imbalances procedure, establishment of the European Financial Stability Fund / Mechanism (EFSF / ESM), the European Banking Union (incomplete, under development) and ECB with double role: lender of the last resort and buyer of the last resort under Expanded Asset Purchase Programme with all its components.

The "safety trilemma" (van Riet, 2017, p.32) shows that only two out of three elements can be achieved, never all three of them: investment in a risk-free asset is not compatible with a free open market for capital and a stable monetary union, because of the implicit elements – when sovereign bonds do not generate yields, they are sold in exchange for liquidity that triggers flows of capital in search for higher returns / yields and assuming higher risks therefore the safety and guarantees of sovereign bonds make these instruments incompatible.

The best solution would be a monetary union and a fiscal union with a European Finance Minister and a European Treasury (as showed in this article, it requires the political consensus and will). The alternative seems to be the synthetic Eurobonds but it involves also a moral hazard: participation should be conditioned by sound fiscal policies and structural policies and phase out the preferential treatment of sovereign government bonds in EU financial legislation. A safe asset in Europe associated with German sovereign bonds is preventing free flow of capital across Euro Area and EU, thus affecting the financial stability of Euro Area (van Riet, 2017).

4. Potential developments in European Sovereign Bond-Backed Securities

The synthetic bond with underlying asset government bonds is a derivative and derivatives are considered speculative investments with high risk. The securitization of Euro Area debt according to any proposed criterion (GDP weights, initial national currencies weights in EUR, etc) reinforces hyerarchy in Euro Area economies, favouring the growth of political economic division (Lagna and Wilhelm, 2017).

ESRB suggests in the survey closed at the end of January 2017, a series of possibilities for the entity (public, private or public-private), the countries (Euro Area or by extension and voluntary adhesion all EU countries), weights assigned to sovereign bonds (countries' contributions to ECB capital), categories of government debt (only central governments), markets (primary or secondary), the size of the market (according to ECB's Public Sector Purchase Programme), cut-off point (70%

senior -30% junior), sub-tranching (possible) and credit enhancements (not needed).

My personal opinion is that for such arrangements to work, the entity (EDA or another chosen name) should follow the securitization procedures and ask rating agencies to give a rating to any new issuance of such synthetic bonds, to be later traded on capital markets. I expect to also impact countries' CDS values and trading. Since CDS are perceived as an insurance-like instrument against the risk of government debt default, would EJB receive a special CDS symbol for trading?

Euronomics suggest in their mentioned studies that due to the existance of junior tranche, any exceeding of 60% debt-to-GDP ratio would actually reflect the default risk of the countries, like CDS. The divergence is that for indebted countries, such a securitization could affect borrowing costs and risk perception, should a country follow an exit procedure from Euro Area at some time.

Derivatives are highly speculative products and speculative investors in search for high returns could "gamble" on european debts like EJB, which would need a financial market for trading. Should such instruments exist at some time, they would have the potential to become disruptive for the markets, as speculative tranzactions would be carried on to hedge the risk, to exploit differentials in prices by short selling or "butterfly spreads" or other high risk techniques in search for a better coverage of speculative profits. It appears there would be a need for regulation and monitoring of markets, instruments and tranzactions.

5. Conclusions

ESRB finally took over the proposals issued over the last years and specifically for ESBies, by establishing in September 2016 a special group "High Level Task Force on Safe Assets" (the mandate is to investigate the potential creation of Sovereign Bond-Backed Securities, which could comprise senior and junior claims on a diversified portfolio of government bonds) and by launching the survey on Sovereign Bond-Backed securities, on December 22, 2016, under the disclaimer that much of the literature and research belong to Euronomics Group and they "provide much of the intellectual foundation for the work of ESRB's High Level Task Force on Safe Assets. However, they are published under the author's responsibility; the ESRB does not necessarily endorse any particular claim or policy proposal they may contain" (ESRB, 2016).

ESRB acknowledges that the creation of Sovereign Bond-Backed Securities is inspired by two key policy objectives: namely, to reduce systemic risk and mitigate financial fragmentation: Sovereign Bond-Backed Securities would reduce systemic risk by allowing banks, insurers and other investors to diversify their government bond portfolios at relatively low transaction costs. Greater diversification is welcome insofar as concentrated portfolios provide a risk transmission mechanism between sovereigns and financial institutions (ESRB, 2015) and Sovereign Bond-Backed Securities would mitigate financial fragmentation by allowing all participating countries to contribute to the supply of low-risk euro assets. At present, low-risk euro assets are supplied asymmetrically, thereby inducing flight-to-safety capital flows across Member States during periods of stress (Lane, 2013).

It remains to be seen whether the implementation of such a proposal, regardless of the name (Euro Safe Bonds, European Sovereign Bond Backed Securities or other name), mitigates the risks of the "diabolic loop" and capital "flight to safety", restoring trust in European safe assets. When ECB will withdraw the monetary stimuli of the expansionary monetary policy, countries will still need to address the imbalances in national fiscal policies and structural problems of economic sectors, issues that the proposed synthetic bonds do not address at all.

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