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Why ESBies won't solve the euro area's problems

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The following guest post on European Safe Bonds is from Marcello Minenna, the head of Quantitative Analysis and Financial Innovation at Consob, the Italian securities regulator. The views expressed here are his personal opinions and do not necessarily reflect the views of Consob.

The euro was supposed to promise financial integration but instead has encouraged fragmentation. Since 2008, banks have retreated within national borders and governments are increasingly dependent on domestic savers for funding.

Weakness in a given country's banking system can cause sell-offs in its sovereign bonds, wounding its home government's finances and weakening the banks further. Scepticism about a government's debt can hit the assets of local banks and encourage deposit flight. Either way you end up with a "doom loop" of tightening credit and market-imposed fiscal austerity.

Part of the problem is that there is no widely available European safe asset. A team of experts led by Markus Brunnermeier of Princeton has proposed a solution using the magic of financial engineering: European Safe Bonds (ESBies).

In their scheme, a supranational vehicle, such as the European Stability Mechanism, would buy government bonds held by euro area banks in exchange for newly issued asset-backed securities.

These would be split into at least two tranches: a large senior tranche — 70 per cent of the portfolio — that would be protected against default by junior tranches worth 30 per cent of the total bond portfolio. This riskier securities would pay higher yields to investors in exchange for being vulnerable to losses. As long as losses on the portfolio of euro area sovereign bonds held by the securitiser are less than 30 per cent, there will be no credit risk to anyone owning the safe securities.

Several European bodies (including the European Systemic Risk Board) and economists have shown remarkable enthusiasm for the ESBies, dubbing them "*Synthetic Eurobonds*". Structured finance would be able to save banks' balance sheets from the excesses of their governments. ESBies would pave the way for the introduction of risk weights on sovereign bonds, as Germany has long been calling for.

ESBies would also provide the ECB with an easy way to gradually liquidate the huge sovereign exposures — more than €1.4tn so far — accumulated during its quantitative easing programme. Bonds held by the eurosystem would end up directly in the securitisation vehicle's collateral

portfolio, averting the need to turn to the market to absorb any sovereign debt issued by any individual country. That in turn should limit further upward pressure on sovereign credit spreads, which have been rising this year.

This is a crucial point for the ECB's assessment of ESBies: a sudden spike in spreads could require the activation of the Outright Monetary Transactions announced in September 2012. So far, this defensive shield has never been used, but should spreads widen too much, OMTs could remain the only card left to play. The problem is that the eurosystem would be forced to repurchase a large portion of the bonds it had just sold, except this time they will only be risky peripheral bonds. (This explains why Germany has traditionally been sceptical of OMTs).

So far, ESBies sound like a major improvement. Unfortunately, they don't solve the essential problem, which is that some countries in the euro area are vulnerable to sudden spikes in real borrowing costs, while others are not.

First, Brunnermeier et al use ESBies as a way to deny joint liability among sovereigns. This is explicitly stated in their paper:

> Sovereigns remain responsible for their own bonds, which would still be traded at a market price, exerting discipline on borrowing decisions. One sovereign could default on its own obligations without others bearing any bail-out responsibility.

ESBies are not Eurobonds. Without joint liability, it is logical for markets to differentiate across sovereign bonds by assigning country-specific risk premia. The lack of risk-sharing therefore leaves the door open for spreads to widen again in times of stress. In this regard, the financial engineering of ESBies do not represent any innovation over the status quo.

It's also not clear how much these new securities would actually help banks in troubled countries.

This is important when considering which investors will be expected to buy the two tranches. Ideally, euro-area banks would hold only the senior securities. In particular, banks of peripheral countries would get a huge asset quality improvement by swapping risk-weighted domestic government bonds with the new risk-free asset of the euro area. By contrast, the proposal claims the junior securities will help investors in search of cheaper ways to bet on the sovereign risk of euro countries.

However, in practice things might deviate significantly from this ideal picture. Peripheral banks have asset return targets based on their funding costs. Swapping out higher-yielding government bonds for lower-yielding ESBies will likely encourage them to search for yield elsewhere, unless bank borrowing costs plunge across the bloc. Peripheral banks might very well end up buying the riskier tranches of ESBies to get some extra return.

As a result, ESBies could end up reproducing the segmentation we see now: senior tranches would replace Bunds in core countries' banks, while junior tranches would take the place of BTPs and Bonos on the balance sheets of peripheral banks. What would be the meaning of this whole operation?

Worse, ESBies might solidify current differences in credit spreads, if not make them wider.

The relative amounts of government bonds to be securitised would be based on either Gross Domestic Product or the ECB's capital key. Neither of these line up with the actual distribution of government debt because some countries have much higher ratios of debt to GDP than others. So if the securitiser agreed to purchase, say, €6tn of sovereign debt — roughly the total amount of euro area sovereign bonds up to 60 per cent of euro area GDP — there would be radical differences in which countries' bonds would get included.

Why does all this matter? Because it indicates that the implementation of ESBies would create a *residuals' issue* in the euro area, with potential problems for peripheral countries. Securitising only part of the public debt of the euro area using GDP weights would nearly eliminate the secondary market for some sovereign issuers while altering the relative availability of the bonds of the remaining issuers.

Most of the public debt of core countries such as the Netherlands, Finland, Germany, and Luxembourg would end up in the collateral portfolio, almost zeroing the government bonds available for market trade. The same would also apply to the Baltic states, as well as Slovakia, all of which have relatively little sovereign debt.

Things would be different for Italy and the other peripheral countries, but also for France and Belgium. The table below shows the full picture:

Country	Public Debt 2016 (€ bn)	Weights (ESBies proposal - GDP proportional)	Govies in the Collateral Portfolio	Govies in the Collateral Portfolio /Debt
Germany	2140	28,2%	1690	79%
France	2147	21,3%	1275	59%
Italy	2218	16,5%	991	45%
Spain	1107	10,8%	646	58%
Netherlands	434	6,6%	397	91%
Belgium	447	3,9%	236	53%
Austria	296	3,2%	193	65%
Greece	315	2,0%	122	39%
Finland	136	2,0%	121	89%
Ireland	201	1,8%	108	54%
Portugal	241	1,8%	107	44%
Slovakia	42	0,7%	40	94%
Slovenia	32	0,4%	22	69%
Lithuania	16	0,3%	15	94%
Cyprus	19	0,2%	11	60%
Luxembourg	11	0,2%	11	98%
Latvia	10	0,2%	10	100%
Malta	6	0,1%	4	70%
Estonia	2	0,0%	2	90%

(Note that the exact figures depend in part on how Greek debt would be included.)

The table below shows the share of government debt that would be excluded from a hypothetical securitisation programme:

Country	Residual Govies (as % of total outstanding debt)
Greece	61%
Portugal	56%
Italy	55%
Belgium	47%
Ireland	46%
Spain	42%
France	41%

In Italy, for example, 55 per cent of the public debt — about €1.2tn of BTPs — would have to be bought by private investors directly, rather than as part of a safe Europe-wide securitisation. Those numbers would be even higher if the securitiser wanted to avoid buying too much debt issued by less-indebted countries, while maintaining GDP weighting.

The net result is that the spread on the unsecuritised debts could *increase* due to the collapse of collateral demand by banks (now satisfied by the ESBies) and the consequent depressive effect on market prices of the sovereign bonds.

The concrete risk is that they become junk with very uncomfortable consequences. Peripheral governments – starting with Italy, which has the highest stock of public debt – would be forced to implement severe budget cuts and tax hikes. Refinancing maturing government debt each year would become quite difficult.

In an extreme scenario the outcome of the whole process could be the abdication of the debt management prerogatives to a *European Debt Agency* and, if domestic reforms are not enough, even the loss of fiscal sovereignty, possibly accepting to host delegations of the Troika as happened in other countries. Really not very tempting!

All of these issues share a common root. The ESBies project accepts as normal what instead is a systematic violation of the economic paradigm: one currency, one risk-free yield curve.

The euro is too young a currency to give up so soon the standard of having a single Treasury curve, as in the United States of America. The shortage of safe assets due to the riskiness of peripheral government bonds should be regarded and managed for what it is: a conjunctural situation that shouldn’t become the *new normality*. Fostering integration requires a complete change of mind aimed at achieving a single yield curve. There are no alternatives.

A first step in the right direction could be transferring bonds purchased by the National Central Banks to the ECB’s balance sheet and held there until the integration process has reached a more advanced stage. This intervention would automatically cancel the loans that the NCBs of the euro

countries have borrowed from the ECB to fund the purchases of sovereign securities, thereby deflating the balances on the Target 2 system that have lately reached worrying dimensions.

Such a measure would be a strong signal for the markets of a reconstituted harmony, spirit of cooperation and mutual support among the euro area countries. The positive response of traders would accelerate the convergence process between the sovereign yields of the various member states just as it did in the late 1990s with the *Germanisation* of interest rates.

In addition, the proposed measure would be an important precedent for wider initiatives: the next step could be the transfer to the ECB of all the public debt of the member countries up to a certain threshold, for example 70 per cent of GDP, which approximately corresponds to the German figure. (This would make more sense than using the famous 60 per cent of the Maastricht Treaty, which *inter alia* has no particular validity in the field of economics.)

These interventions would restore a single sovereign yield curve across the euro area. The problems of collateral shortage and the "doom loop" between banks and states would be automatically solved. Bonds issued by every member country will return to being perfect substitutes of each other and all risk-free assets, making it unnecessary to introduce different risk-weights for the purposes of banks' capital requirements.

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