BRIEFING

European Parliament

Are Sovereign Bond-Backed Securities ('SBBS') a 'self-standing' proposal to address the sovereign bank nexus?

Further to the adoption by the Commission of a proposal for a Regulation on sovereign bond-backed securities ('SBBS') on 24 May 2018, this briefing outlines the main purposes of this "enabling regulatory framework" for the development of SBBS. SBBS have been presented by the Commission as a market-driven initiative. By removing regulatory obstacles that have hindered its development, this enabling framework would put SSBS to a market test. In that context, SBBS has been portrayed by Commission Vice President Dombrovskis at the May 2018 structural dialogue as "a proposal on its own". This briefing focusses also on significant differences between the original ESRB proposal and the concept of SBBS, which no longer suggests institutional changes nor amendments to the existing regulatory treatment for sovereign debts. Absent such 'flanking' measures to SBBS, the question is raised as to whether SBBS as proposed by Commission would be met by sufficient demand.

1. An enabling regulatory framework

What are the origins of the SBBS proposal?

SBBS - initially called European safe bonds (ESBies) - was proposed in 2011 by a group of economists ('the euronomics group') **to promote a type of "European safe asset"** (hereafter the ESBies) as an alternative concept to the idea of Eurobonds that involved mutualisation of sovereign debt. The same group of economist further outlined their proposal in a Working paper ("ESBies: Safety in the tranches") published by the European Systemic Risk Board (ESRB) in September 2016. In 2016, the ESRB General Board agreed that the pooling and tranching of cross-border portfolios of national sovereign bonds represents an interesting and attractive approach that could contribute to the ESRB's objectives. On this basis, the General Board commissioned a *High-Level Task Force on Safe Assets*, chaired by Philip R. Lane, Governor of the Central Bank of Ireland and member of the Euronomics group, to investigate the "*practical considerations relating to sovereign bond-backed securities (SBBS)*". This High Level Task Force (hereafter also ESRB task force) published its findings in January 2018 (hereafter also ESRB-SBBS). Further to the January 2018 ESRB task force report, the Commission adopted a proposal on SBBS on 24 May 2018 (hereafter also the COM-SBBS).

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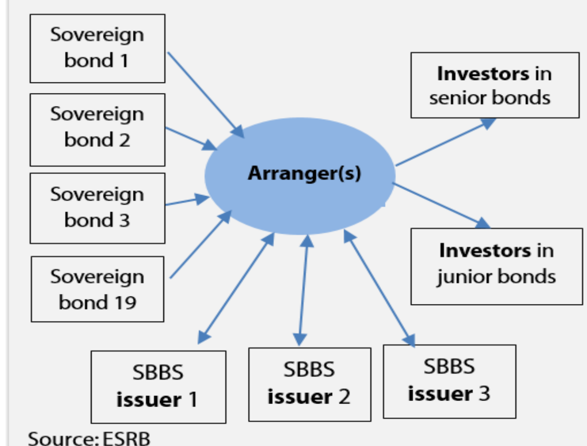
Box 1: Balance sheet of a special-purpose entity issuing SBBS

Assets	Liabilities	
Sovereign bonds of all Eurozone Member States (ECB capital key weights)	Senior tranche	70%
	Mezzanine tranche	
	Junior tranche	

Box 2 : SBBS issuance model



Source: ESRB

'SBBS' are a securitised instrument composed of at least two tranches that are offered to investors, backed by a pool of sovereign bonds of all Euro area Member States . Its senior tranche is the one which is more secure for investors, while the riskier junior tranche shall absorb losses and serve as buffer for the senior bonds. The Commission proposed that the senior tranche shall correspond to seventy percent of the nominal value of an SBBS issue, to ensure standardisation of tranches across different issues (see Box 1), save for exceptional cases[1]. SBBS will be issued by dedicated Special-Purpose Entities ('SPE'), as for other securitisations.

On the asset side of the SPE, the cover pool is composed of sovereign bonds of all euro area Member States denominated in euro, proportional to the ECB capital key[2], save in specific circumstances[3].

Conceptually, both the ESBR and the Commission reflected upon whether (and with which metrics) to further split the junior tranche into, for example, a so-called mezzanine tranche and a junior tranche.

The ESRB task force specifically assessed a structure with two subordinated tranches: a mezzanine tranche amounting to 20% of the nominal issuance and a junior tranche for the remaining 10% (See box 1). Numerical simulations by the ESRB found that a 70%-thick senior SBBS tranche would have "*expected and unexpected loss rates similar to German sovereign bonds*"[4], which carry an AAA rating. This has been questioned by Standard & Poor's (See Part 3 and Box 4).

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[1] The Commission proposes that the tranching structure may be changed in exceptional cases by means of a Commission implementing act, where adverse market developments that severely disrupt the functioning of sovereign debt markets in a Member State or in the Union require a smaller senior tranche to ensure its continued high quality/low risk.

[2] The capital key reflects the respective member's share in the total population and gross domestic product of the EU. ECB capital key share among euro area Member States is as follows: AT: 2,79%; BE: 3,52%; CY: 0,21%; DE: 25,57%; EE: 0,27%; ES: 12,56%; FI: 1,78%; FR: 20,14%; EL: 2,89%; IE: 1,65%; IT: 17,49%; LT: 0,59%; LU: 0,29%; LV: 0,40%; MT: 0,09%; NL: 5,69%; PT: 2,48%; SI: 0,49%; SK: 1,10%.

[3] The Commission proposal contains some flexibility to adapt the composition of the pool in view of the limited sovereign debt in some Member States (see Article 4(3)).

[4] The ESRB task force has assessed that the assumed worst case scenario - the isolated event of a German default with 100% LGD (Loss Given Default) - would impose losses of less than 30% (which would be absorbed by the junior tranche). With a 37% LGD (which is the average haircut on sovereign debt restructuring), the senior tranche would not be affected if all Member States but Germany default.

Procedurally, the issuance model of SBBS works as follows: private arrangers (typically investment banks) first source sovereign bonds, then transfer them to an issuer (i.e. the SPE) that will 'manufacture' the SBBS, and the SPE then passes the SBBS to investors (see Box 2). The involvement of private arrangers and SPEs needs to be covered by managerial charges.

The COM-SBBS concept does not entail joint liability among Member States, unlike e.g. Eurobonds that were proposed in a Commission Green paper of November 2011[5]. The European Parliament 2017 Banking Union report *recall[ed] that SBBSs would not constitute a form of debt mutualisation*. By combining pooling and tranching, SBBS are meant to create a safe asset that would not be guaranteed by Member States and would only rely on the quality of the underlying asset pool.

Under the COM-SBBS proposal, each Member State keeps full responsibility for managing the issuance of its own debt, including a default. The default of a sovereign bond would result in the reduction of incoming cash-flows to the SPE, resulting in reduced (or no) payments to junior bond holders.

In designing ESRB-SBBS, particular attention had been paid to prevent Member States from conducting off-market purchase of SBBS as a crisis management tool, which would come down to 'backdoor mutualisation" (as the ERSB report calls it). Three key principles have been worked out by the ESRB task force to limit this risk. Those principles aim to ensure that SBBS be given the same market access as their underlying sovereign bonds:

- The cover pool of newly issued SBBS only contains bonds which have - or had at the time they were purchased - access to the market. This condition is reflected in Commission's proposal ('market access criteria')[6];
- SBBS issuers pass on payoffs from the bond pool to SBBS investors, without adding any substantial risks. The latter condition is achieved by ensuring that SPE issuing SBBS are 'bankruptcy remote' from their arranger (see Box 2). Those requirements are included in Commission's proposal (See Article 7(2));
- In a restructuring event, sovereign bonds in the SBBS should be restructured in the same way as equivalent sovereign bonds held by investors directly ('principle of equal treatment')[7]. The COM-SBBS proposal does actually not further elaborate on this principle but requires information to investor be made available on that issue (Article 12).

Objectives of SBBS

SBBS are presented by Commission as a "pragmatic solution to reduce the bank-sovereign loop" for the following reasons:

The Commission expects the development of the SBBS market to help banks diversify their holdings of sovereign bonds (see EGOV briefing with respect to banks' exposures to their home Member States). The Commission's impact assessment accompanying its proposal has assessed the

[5] For a presentation of Parliament's position on common issuance of bonds, see the EPRS briefing "Sovereign bond-backed securities - risk diversification and reduction", August 2018. The European Parliament resolution of January 2013 on the feasibility of introducing stability bonds called on the Commission to present a roadmap towards common issuance of public debt instruments.

[6] Commission's proposal introduces a mechanism whereby sovereign bonds of Member States that have financed at least half of its annual funding requirements through official financial assistance (macro-economic adjustment programme) over the previous year are excluded from the sovereign pool.

[7] In its report (volume 2), the ESRB HLTF suggests introducing in the SBBS Regulation a non-discrimination provision that includes a comprehensive definition of actions with which governments might seek to influence the returns or value of bonds (e.g. offering a debt exchange) and a stipulation that if any such action makes some creditors better off, it will automatically apply to all creditors, including SBBS issuers.

diversification of banks' sovereign portfolio against two different scenarios: (i) under a limited volume scenario, whereby SBBS reach an overall volume of EUR 100 bn, the reduction of domestic holding would amount to -3% ; (ii) Under a "steady state scenario, whereby SSBS reach an overall volume of EUR 1.500 bn, the reduction will amount to -34%.

At workshops organised by the ESRB, it was noted by many commercial banks that SBBS could incentivise diversification if at the same time capital charges for concentrated portfolios were introduced. The Commission, however, does not propose changes to the Regulatory Treatment of Sovereign Bonds ('RTSE') (see Part 2).

Moreover, under the current rules, banks are free to invest in whatever mix of sovereign bonds they prefer. One may therefore question whether the SBBS concept actually increases, or rather reduces the choice of bonds to invest in.

SBBS aim to provide a broader EU safe asset, making a 'flight to safety' unnecessary. The 2013 EP resolution on stability bonds urged Member States to study the feasibility of moving towards a system of European Safe bonds or to other proposals based on the concept of a basket of bonds. Used as collateral, for monetary purposes, on prudential grounds or as safe haven for investors, safe assets are an essential element of robust financial systems to shield against default risk. From a financial stability point of view, the main purpose of SBBS would be to make a flight to safety unnecessary, preventing that - as during the financial crisis - investors suddenly shy away from bonds of individual Member States that are suddenly perceived to be too high a risk, replacing those with low risk assets. SBBS are expected to limit capital flights that Member States hit by the sovereign crisis[8] have experienced. According to the Commission's impact assessment, the share of AAA assets in the banks' average portfolio would increase from 24% to 32% in the "steady state scenario", in which SBBS account for an overall volume of EUR 1.500 bn.

SBBS may also help with 'making tangible progress' on the RTSE issue (Regulatory Treatment of Sovereign Risk)**.** At the 17 May 2017 ECON structural dialogue, Vice President Dombrovskis stressed that SBBS should be assessed on "its own", irrespective of the broader debate around mutualisation of debt and the treatment of sovereign risk weights that the SBBS proposal does not purport to achieve. The Commission has not suggested in its proposal any changes to the sovereign risk weights. While SBBS is not about the regulatory treatment of sovereign bonds, the Commission's 0ctober 2017 Banking Union communication has explicitly linked the development of SBBS to the broader debate of the sovereign risks treatment: "*In order to make tangible progress on this matter [i.e. regulatory treatment of sovereign bonds], so-called sovereign bond-backed securities (SBBS) could as a first step have the potential to contribute to the completion of the Banking Union and the enhancement of the Capital Markets Union*". Put another way, as emphasised in the 2011 SBies paper, changing the RTSE "*would only be fully effective without creating problems of its own if banks had an alternative safe asset to hold*".

The COM-SBBS proposal has met criticism from some stakeholders which pointed to a number of technical issues. Some of the issues raised are set out in more detail in Box 3.

A market test by removing regulatory obstacles

SBBSs' development comes up against existing prudential treatment. Under the EU *acquis*, SBBS would be treated as a 'securitisation" position requiring higher capital charges. According to the Commission's impact assessment, that treatment would explain why SBBS have not been developed

[8] As explained by the Cologne Institute for economic research, "if Greek banks had held senior SBBs instead of national sovereign bonds, the losses resulting from the Greek default in 2012 would have been absorbed solely by the holder of the junior SBBS tranche. They would also have been able to retain refunding in money markets by using the senior SBSs as collateral. Thus, there would have been less capital flight from Greece".

so far as a market-driven initiative. The Commission's proposal on SBBS aims to align the prudential treatment of SBBS to that of sovereigns (i.e. 0% risk weight under the Capital Requirement Regulation in banking[9]) in order to overcome regulatory obstacles to the development of SBBS.

As the Commission's impact assessment puts it, by removing regulatory obstacles, the proposal is simply an "enabling" framework that puts SBBSs to a market test. In that respect, the HLTF report concluded that "*ultimately, the level of investor demand for SBBS and its impact on financial markets is an empirical question, which can only be tested if an enabling regulation for the securities is adopted*".

Box 3: Some critical points raised about the SBBS proposal

SBBS not needed to diversify sovereign risk. Banks already have full discretion in their diversification and securitisation strategies as opposed to investing in a fixed composition of underlying sovereign bonds. Please see Part 1 (Objectives) for a discussion of this issue. The STS Regulation (framework for simple, transparent and standardised securitisation) will also have an impact on how institutions manage their overall investment strategy.

Insufficient diversification of the cover pool. Given the limited number of systemically correlated assets involved, the cover pool would not be sufficiently diversified to be comparable to collateralized debt obligation (CDO), as pointed out by the rating agency Standard & Poor's. Please see Part 3 for a discussion of this issue.

Costs and risks related to the issuance of SBBS. Critics have pointed out that the process of assembling the cover pool creates a warehousing risk. Please see Part 2 (Design of a SPE) for a discussion of this issue. In addition, issuance of SBBS carries managerial costs that have to be covered.

Lack of suitable buyers for the junior tranche. Some critics argue that there are not sufficient suitable buyers available for the risky junior tranche, and that it would be particularly difficult to find buyers for the junior tranche in times of crisis. In addition, one may need to consider whether these instruments are suitable for wider distribution. Please see Part 3 (market for the junior tranche) for a discussion of this issue.

Risks to financial stability. Some critics argued that the Commission's proposal to give it a 0% risk weight for the prudential treatment of the junior tranche runs counter to financial stability objective. Please see Part 2 (Should SBBS be accompanied by a RTSE reform) for a discussion of this issue.

Perception in times of crisis: De Grauwe and Ji assume that in a crisis situation, investors would likely flee the senior tranches of the SBBSs to invest in the 'real thing', i.e. super-safe sovereign national bonds. Pease see Part 3 (SBBS in stressed situations) for a discussion of this issue.

2. Where has the Commission positioned itself in the policy debate?

The Commission's proposal is the outcome of policy choices in terms of design of the Special Purpose Entity (SPE), regulatory treatment of sovereign exposure and governance that have been intensively discussed as part of the ESRB task force. There are significant differences between the ESBies' original proposal from euronomics (ESBies), recommendations of the ESRB's HLTF (ESRB-SBBS), and the Commission's proposal (COM-SBBS), as outlined in Table 1. In many aspects, the Commission's proposal took a lighter regulatory approach. Some have considered that a preferential treatment in terms of RTSE and collateral framework would be instrumental for SBBs to meet market demand.

[9] This is achieved by extending to all tranches of SBBSs the look-through approach (i.e. 0% risk weight of the underlying exposure) granted to the exposure to securitisation positions in the calculation of capital requirements

How to design the SPE?

The question has been raised as to whether a 30% subordination would provide enough protection to holders of senior bonds. In their original proposal, Euronomics suggested an additional layer of protection for the senior tranches in the form of a public guarantee provided by Eurozone Member States that was only to be triggered in case default losses exceeded the 30% tranching cut-off. However, such additional credit enhancement by means of a public guarantee has not been proposed by the ESRB and may have entailed further problems (Stability and Growth Pact and State Aid related). To ensure additional safety for senior bondholders, the Commission has suggested that the size of the senior tranche may be changed in exceptional cases further to an implementing act of the Commission[10]. Put it another way, the Commission's proposal recognises that a 30%-thick junior tranche may not be sufficient to adequately protect the safe assets under severe adverse developments on sovereign bond markets, but has no further protection mechanism built-in. Originators are not prevented, however, to put forward additional enhancement mechanisms, subject to adequate transparency and compliance with the securitisation framework and "true sale" requirements.

In terms of tranching, the 30%-thick junior tranche that has been originally proposed by Euronomics in 2016 - combined with the assumption that a large amount of SBBS shall be placed on the market - has been deemed "*too large for specialist high-yield investors to absorb in significant quantities*", according to the ESRB. The junior tranche could have been perceived by investors as being too risky to attract sufficient demand in particular in times of crisis. Against that background, the ESRB suggests to create a 20%-thick mezzanine tranche with characteristics similar to those of lower investment grade sovereign bonds, on top of a 10%-thick junior tranche. The Commission's proposal makes no prescriptions about the structure of the subordinated tranches and includes no specific references to junior and mezzanine tranches[11], which would have to be designed so that the junior tranche meets market demand.

The question as to whether coordination between debt management offices ('DMO') needs to be secured has a significant bearing on the design of SBBS issuance. Member States have strongly objected to a coordination between debt management offices on the ground that it may undermine the functioning of the underlying sovereign bond market and thus, their financing strategies: "*The necessity of issuances and hence coordination for the purposes of SBBS will create some mismatches with regard to the particular timing of financing needs for each sovereign*" (letter of the EFC Sub-Committee on EU Sovereign Debt Markets). Absent a coordination of sovereign issuance for the purposes of SBBS, arrangers of SBBS face a 'warehousing' risk[12], since sovereign bonds are not issued simultaneously in all Member States and carry different maturities. SBBS arrangers would need to fund their warehouse of sovereign bonds during the process of assembling the cover pool. Sourcing the bonds from the secondary market was considered by stakeholders at ERSB workshops "*operationally challenging, although not impossible*". The ESRB report suggests that SBBS arranger fill an order book before assembling the cover pool whereby investors commit to purchase securities from the arranger. The use of an order book would ensure that SBBS issuance is demand-driven minimising warehousing risks for arrangers. This issue is not specifically addressed in Commission's proposal.

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[10] "Where adverse developments severely disrupt the functioning of sovereign debt markets in a Member State or in the Union, and where that disruption has been confirmed by the Commission SPEs shall lower the outstanding nominal value of the senior tranche to sixty percent for any SBBSs issue issued after that confirmation".

[11] In accordance with Article 6(1), the junior tranche should nevertheless be at least 2% of the outstanding nominal value of the entire SBBS issue.

[12] Warehousing risks involves keeping the risk on the SPE balance sheet before passing it on to investors.

Should SBBS be accompanied by a RTSE reform?

While SBBS is not about the treatment of sovereign exposures, the ESRB noted in its report that the regulatory treatment of sovereign exposures would affect the relative attractiveness of SBBS compared with sovereign bonds: "*any regulatory treatment of sovereign exposure that is sensitive to concentration or credit risk would substantially enhance demand for senior SBBS insofar as banks and insurance corporations could use that security to mitigate the resulting impact on capital requirements*"[13].

The question as to whether SBBS should be accompanied by a change in the regulatory treatment of sovereign exposures has been debated at the ESRB[14]. The ESRB task force echoes in its report of January 2018 two different schools of thoughts:

- For some, an SBBS market could only develop following a comprehensive RTSE reform that would incentivise banks to reinvest into senior SBBS. In that respect, the Chair of the HLTF of the ESRB, Philip Lane, took the view that '*reforming the regulatory treatment of sovereign exposures would substantially enhance demand for SBBS. This is because banks could use senior SBBS to mitigate the resulting impact on capital requirements*".
- For others, according to the ESRB report, "*RTSE reform would be unnecessary to counteract market misperceptions of SBBS as the two issues are unrelated*". RTSE reform would be "*undesirable, particularly in the absence of a functioning SBBS market*".

By keeping the RTSE unchanged in its proposal, the Commission has adopted the latter approach. In that respect, the Commission noted in its impact assessment that a 'no RTSE change' scenario is in line with the conclusion of the discussion at international level[15].

The Commission proposal suggests a full regulatory 'neutrality' for the prudential treatment of all SBBS tranches. Not only the senior tranche (i.e. the more senior), but also the junior (and mezzanine tranche, where appropriate) will attract a 0% risk weight and be eligible as High Quality Liquid Assets (HQLA) for the purposes of complying with the Liquidity Coverage Ratio (LCR)[16]. This approach has been assessed by the Commission as the most promising option against the objective of maximising the 'enabling' effect of the proposed legislation. A differentiated treatment would expose banks to higher capital requirements when holding the clearly more risky junior tranches, which the Commission sees as impinging the SBBS development.

In contrast, the ESRB report stressed the importance of a differentiated regulatory treatment of SBBS tranches on financial stability grounds: "*non-senior securities would be risky and should be treated by regulation as such to ensure that banks and others benefit sufficiently from the de-risking possibility that SBBS provides. Otherwise, the introduction of SBBS could endanger financial stability by allowing banks to increase their exposure to sovereign risk. To avoid this outcome, holdings of mezzanine and junior securities should be subject to restrictions, such as risk weights that reflect their relative riskiness and/or position limits*".

The 2016 ESBies paper takes a more radical approach. They suggest exempting ESBies from capital charges and exposures limits to encourage their issuance, while other sovereign bonds would receive a capital treatment commensurate to their risk: "*this regulatory choice is analogous to that*

[13] The ESRB insisted in its report that this "finding does not pertain to the overall merits or demerits of such reform; this assessment should be made in other policy area owing to its broader implications".

[14] See box 4.A of the ESRB Sovereign bond-backed securities: a feasibility study, January 2018, Volume 1s.

[15] In its December 2017 Discussion Paper on "The regulatory treatment of sovereign exposures", the Basel Committee noted that it "*has not reached a consensus to make any changes to the treatment of sovereign exposures, and has therefore decided not to consult on the ideas presented in this paper*".

[16] As explained in the explanatory memorandum accompanying Commission's proposal, Commission intends to change the Liquidity Coverage Ratio Regulation (Commission Delegated Regulation (EU) No 2015/6110) accordingly.

made in the United States, where Federal Treasuries have a zero risk weight but municipal and state bonds do not".

In addition, both the ESRB and the Euronomics suggest some form of limitation of banks' exposure to junior SBBS.

How to organise the governance of the SBBS market?

Consideration has been given as to whether SBBS should be issued by private or public issuer. As originally proposed, ESBies were issued by a "European Debt Agency". The Euronomics were doubtful that private financial institutions would create ESBies spontaneously. The ESRB task force has further assessed whether SBBS could be issued by the ESM without changing the ESM treaty. According to the ESRB task force, under existing rules, the ESM could only have, where appropriate, a limited involvement as an arranger or provider of technical assistance.

The ESRB HLTF leaves open whether the arranging entity should be public or private while noting that a significant public sector involvement carries the risk of SBBS being misperceived as benefitting from an implicit guarantee. The enabling framework of Commission's proposal is geared towards private issuance. In that context, Commission's proposal lays down supervisory requirements governing the issuance of SBBS as recommended by the ESRB task force. Supervision will be conducted by Member States competent authorities in coordination with ESMA. To monitor the standardisation of SBBS, ESMA would be notified of planned SBBS issuance.

Given the potential impact of SBBS on the liquidity of sovereign bonds, the issue has been raised as to whether the issuance of SBBS should better be capped. Debt Management Offices ('DMO') echoed in a letter of the EFC Sub-Committee on EU Sovereign Debt Markets the concerns over the impact that SBBS may have on national sovereign bonds markets: '*In order for SBBS to be successful, they would need to reach a sufficient size. However, large sized SBBS would negatively impact price formation and liquidity of the existing sovereign bonds, and hence the sovereign refinancing costs, particularly affecting small and medium sized sovereign debt market*'. Commission's impact assessment acknowledges a trade-off between the liquidity of sovereign bond markets and the liquidity of SSBS: "*A large SBBS market implies adequate liquidity of the asset, but potentially at the expense of national sovereign debt market liquidity. On the contrary, a small SBBS market would have limited knock-on effects to national sovereign debt market, but may consequently itself be illiquid*". Against this background, the markets for sovereign bonds must remain large enough so as to maintain their liquidity. SBBS issuance requires price formation in sovereign bond. In that respect, the ESRB suggested to limit the total SBBS issuance to 1.500 bn coupled with an issuer limit of 33% of the total outstanding stock of sovereign bonds, to limit the impact of SBBS on the liquidity of sovereign bonds markets. 1.500 bn is the volume that Commission's impact assessment aims at in the steady stage. In the same vein, the ESBies proposal suggested a ceiling of 60% of the GDP. Unlike the ESRB report[17], the Commission proposal does not suggest a mechanism to control the volume of issuance.

It was seen a necessary precondition that senior SBBS would be eligible for placement as collateral at the ECB. The Euronomics suggest that ECB grants strict preferential treatment to ESBies that would be accepted as the main form of collateral in the Euro system repo and discounting operations. In contrast, the ESRB task force report insists only on the recognition of SBBS as eligible in Eurosystem monetary operations. The existing rules governing collateral eligibility already include some asset-backed securities, but not sovereign bonds structures. The ECB mentioned at the Commission's expert working group that it will express its position only after the adoption of the proposal.

[17] The HLTF suggests that an authority issues "SBBS licence numbers" and places a cap on SBBS market size.

Table 1 - Comparison of the ESBies and the SBBS proposals

Characteristics		ESBies	SBBS- ESRB	SBBS- Commission
SPE	**Tranches**	70% senior 30% junior	70% senior 20% mezzanine 10% junior	70% senior One or more subordinated tranche
	Changes to the structures	Not specified	Not specified	Possibility to decrease senior tranche down to 60% in adverse market developments
	Public Guarantee	ESM for the senior tranche ('credit enhancement')	No	No
RTSE	**Sovereign risk weights (RW)**	0% RW for ESBies (i.e. senior tranche)	0% RW for SBBS (senior tranche)	0% RW for SBBS
		Specific RW for the junior tranche	Specific RW for the junior tranche	0% for the junior tranche
		Specific RW for MS sovereigns (transition period)	Mixed views regarding RW for MS sovereigns	0% for MS sovereigns
	Holding of junior tranche	Banks only allowed to invest in senior bonds	Banks should not excessively hold junior bonds	Not specified
Governance	**Arrangers of SBBS issuance**	European Debt Agency (2011) Private and/or public (2016)	Private or public Public arranger may imply a certain degree of mutualisation	Private issuance
	Ongoing supervision	Not needed (European Debt Agency)	Licensing regime for SBBS arrangers by a competent EU authority	Competent authorities designated by MS Cooperation with ESMA Notification to ESMA
	Ceiling of SBBS issuance	Hard limit of 60% of GDP	Public authority (licenses and cap)	No
	Collateral	Main form of collateral in the Eurosystem framework	Recognised as collateral	To be specified by ECB

Source: EGOV

3. Would there be market demand for 'SBBS'?

By design, junior tranches are issued together with the senior tranche. This means that SBBS issuance is contingent on whether investors have collectively placed orders for all securities, including the junior tranches in stressed situations. SBBS issuance is hence an entirely demand-led process. Concerns have been raised as to whether Commission's policy choices outlined in Part 2 would facilitate market acceptance of SBBS. As the IMF in its Article IV report for the Euro area put it, "*it would remain to be seen whether this change alone would allow the three tranches to find uptake in the credit market*".

Is there a market for the junior tranche?

In accordance with ESRB's report, the expected investor base for junior SBBS tranches are investors looking for higher risk-return investment. Market participant have expressed strong doubts about the market acceptance of the junior tranche:

- For Member States' Debt Management Offices at the EFC: "*the existence of an investor class willing and able to hold the subsequent large size of the junior tranche has yet to be demonstrated*";
- For AFME, it is "*unclear whether there would be sufficient market capacity to absorb*" a 10%-thick junior tranche.

The concept of SBBS only holds where all tranches - including the junior tranche - can be sold to investors. As a research paper from the Cologne Institute put it, "*if the market for the junior tranche broke down, the whole concept would collapse*". In that respect, the Euronomics have suggested that the European Debt Agency secures the sell-off of the junior tranches before acquiring the sovereign bonds. A limited market for the junior tranche may nevertheless result in higher interest payment that may unravel the SBBS's business model. At the ESRB workshops, some participants claimed that "*the prospective holders of junior SBBS would require a high return such that the yield on senior SBBS would be negative in the current interest rate environment*".

Market demand for junior tranches might also depend on investors' assessment of Eurozone Member States debt sustainability. As explained by the ESRB task force: "*the attractiveness of junior SBBS depends on clear communication to investors that the euro area policy stance on fiscal discipline will not weaken as a result of SBBS issuance*". In that respect, it has been suggested to condition the participation of Member States' sovereign bond in the pool of SBBS assets on its fiscal sustainability. While such safeguards would ensure the viability of SBBS according to the Cologne Institute, this additional safety will come at the expense, on the other hand, of a lesser degree of diversification across Member States.

One would expect that experienced investors invest into the mezzanine and junior tranches, considering their subordination. Notwithstanding, risks may still be passed on to retail investors through different investment vehicles, such as collective investment schemes. Therefore, it would be important to ascertain whether the supervisory framework, along with the safeguards for purchasers, is adequate considering the risks entailed by the SBBS and in particular the junior tranche. The issue is not specifically addressed in the Commission proposal. In any event, the Commission proposal entails transparency towards investors in relation to the specific characteristics of the SBBS. In particular, article 11 of the Commission proposal seems to require both ongoing and initial information (either in the form of a prospectus under existing EU legislation or through specific ad hoc information) allowing investors to assess the risks of the instrument. One additional interesting feature of the instrument is that the competent authorities are granted powers of intervention in case of SPE's misconduct (Article 14(3)).

Is there a market for the senior tranche?

In accordance with ESRB's report, euro area banks are expected to be significant holders of SBBS senior tranche since senior SBBS would facilitate the diversification and de-risking of banks' sovereign bond portfolio. While some banks may likely buy a certain amount of senior SBBS in order to better stabilise their funding position in times of a future sovereign debt crisis, it may be questioned whether all banks would follow suit. As noted by the Cologne Institute for economic research, « *German banks might tend to favour German bunds as safe assets over a new and untested asset class* ».

Doubts have been cast on whether demand would exist for SBBS in the absence of a regulatory changes to the sovereign risk weight treatment. In a policy paper, a group of 14 economists[18] advocated for SBBS while noting that "*because assets of this type should both be attractive to banks seeking to reduce concentrated sovereign exposures and create demand for the bonds of these sovereigns, they should ideally be introduced in parallel with a regulation on limiting sovereign concentration risk in a way that would avoid disruptive shifts in the demand for euro area sovereign bonds*";

More fundamentally, market participants have questioned the very concept of SBBS compared to existing financial instruments: "*Asset-backed securities have traditionally been less liquid than government bonds. Therefore it is unclear to us whether a sufficiently large pool of investors would be attracted to SBBS as investors can already build portfolios replicating what would be the underlying portfolios of SBBS, with the ability to shift risk more easily than if they were holding tranches of SBBS*" (Consultation response of AFME).

In addition, the "market test" provided for by Commission's enabling framework would importantly depend on the market perception of SBBS credit worthiness. In that respect, Standard & Poor's already cast some doubts over its AAA treatment (see Box 4).

Box 4: Standard & Poor's credit rating assessment of SBBS

Based on the 2016 ESRB working paper, S&P provided the following assessment:

- ESBies will probably reduce the supply of 'AAA' rated assets, since some 'AAA' rated sovereign bonds are likely to be repackaged into lower-rated ESBies.
- Given the lack of diversification of the sovereign bond portfolio underlying ESBies, and the high correlation of Eurozone sovereign default risk, we would likely rate ESBies in the lower half of the investment-grade category

In addition, S&P representatives interviewed by Politico further explained the following in relation to COM-SBBB:

- **Concentration:** "Such a portfolio of government bonds has a level of concentration when you consider that there are only 19 sovereigns packaged into it. We think it'd be less effective than for corporate bond portfolio. In a securitization, you'd normally have 60 to 100 names, which are typically with different geographies and industries to maximize the diversification benefit."
- **Correlation:** "You'll see much higher correlation between the eurozone sovereigns. This concentration and high correlation than what we see in corporate securitization make the securitization tool less powerful and efficient to provide support to the senior tranches. It is more likely the default will go through the portfolio."
- **Liquidity support:** "If there was one day a default on one or more of the underlying sovereign bonds, you would need funding and liquidity support to continue to pay coupons while recovery proceedings are taking place. "There is also an absence of external support [in the current proposal]."

Credit ratings of SBBS would mainly depend on whether this financial instrument brings about the required level of diversification and low correlation. In that respect, it must be noted that the ECB capital key used for sovereign debts' allocation would result in 80% of SBBS portfolio being invested in DE, FR, IT and ES sovereign bonds. In terms of correlation, the sovereign debt crisis of 2010-12 has shown how correlated government bond yields are in bad times. According to some research

[18] "Reconciling risk sharing with market discipline: A constructive approach to euro area reform" - group of 14 French and German economists.

papers, the sovereign bond yields of the periphery countries under stress were highly positively correlated and at the same time negatively correlated with the yields of the core countries.

At inception, SBBS are very much likely to have difficulty to meet significant market demand, as the market would lack liquidity. For the market to steadily develop, it has been argued that policy intervention may be needed to catalyse the market for SBBS. In that respect, the 2016 ESBies paper suggested a "centralised swap mechanism" whereby banks could swap a portfolio of sovereign bonds for senior SBBS and junior SBBS.

SBBS in stressed situations

Market acceptance of SBBS is contingent on whether SBBS would be seen as providing a safe assets in bad times. In a note, Bruegel expressed serious misgivings about the ability of SBBS to whether financial stress for the following two reasons: "*First, the ESRB insists that sovereign bonds of countries losing market access will not be included in the pooling*[19]*. Second, for other countries, finding buyers for junior SBBS in bad times would become crucial as this would limit the possibility of issuing any SBBS at all during stress periods*". It has also been argued that crisis situations witness not only a flight to safety but also a flight to simplicity, which may disqualify structured products. In the absence of a market for the junior tranche in stressed situations, SBBS may carry the risks of 'bail-out' that has been portrayed by the Cologne Institute as "a risk of an unconditional debt mutualisation in times of severe crisis". To fend off that bail-out risk, the Euronomics suggested that the statutes of the European Debt Agency explicitly forbids a capital guarantee being used for any purpose beyond absorbing losses for the senior tranche. The ESRB task force has elaborated key principles (see Part 1) that aim at avoiding that risk.

Assessing how SBBS would be dealt with in stressed situations is expected to raise critical questions as to the governance of the EMU. As pointed out by the EFC Subcommittee on EU Sovereign Debt Markets '*from a broader and more fundamental point of view, assessing the risk and payoff of such a complex financial product as SBBS implies necessarily assessing the probability of a partial or generalised sovereign default event in the Eurozone*', which implies "*initiating debates on very complex and politically sensitive issues*". This broader policy debate was echoed in the 2011 paper on ESBies, which called for "*a credible, orderly, bankruptcy procedure for sovereigns that minimises the risk of* contagion".

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[19] According to Commission's proposal, sovereign bonds of a particular Member State may be excluded from the underlying portfolio when and until the issuance of sovereign bonds by a Member State is significantly limited due to a reduced need for public debt or impaired market access.