Briefing

EU Legislation in Progress

European Parliament

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13 September 2018

First edition

The 'EU Legislation in Progress' briefings are updated at key stages throughout the legislative procedure.

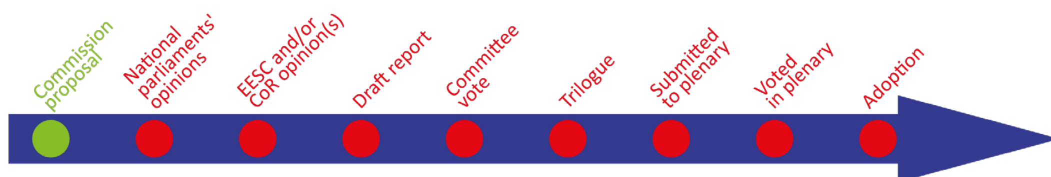
Please note this document has been designed for on-line viewing.

Sovereign bond-backed securities

Risk diversification and reduction

As a part of the European regulatory responses to the financial and sovereign debt crises, the European Commission has proposed a regulation on sovereign bond-backed securities (SBBS), a new class of low-risk securities backed by a diversified pool of national government bonds. The proposal seeks to provide an enabling framework for a market-led development of SBBS, thus encouraging banks and investors to diversify their holdings of euro area bonds. The proposal is meant to address a weakness that appeared during the aforementioned crises, when banks' high exposure to their sovereigns' own debt, coupled with deteriorating creditworthiness of those sovereigns, led to balance sheet strains for banks. This in turn put pressure on government budgets, thus creating mutual contagion and financial instability. The procedure is currently at the initial stage in the European Parliament and the Council.

Proposal for a Regulation of the European Parliament and of the Council on sovereign bond-backed securities	
COM(2018) 339, 24.05.2018, 2018/0171 (COD), Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')	
Committee responsible:	Economic and Monetary Affairs (ECON)
Rapporteur:	Jakob von Weizsäcker (S&D, Germany)
Shadow rapporteurs:	Fulvio Martusciello (EPP, Italy) Bernd Lucke (ECR, Germany) Enrique Calvet Chambon (ALDE, Spain) Martin Schirdewan (GUE/NGL, Germany) Ernest Urtasun (Greens/EFA, Spain) Marco Zanni (ENF, Italy)
Next steps expected:	Publication of draft report



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Author: Angelos Delivorias with Jelena Ulic

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Introduction
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Introduction

The banking union is an EU-level banking supervision and resolution system which operates on the basis of EU-wide rules. One of its aims is to strengthen financial stability in the EU. One way to reduce financial stability risks, in turn, is to weaken the link between banks and their governments by diversifying their sovereign portfolios. On 25 May 2018, the Commission took a step in this direction by proposing to create a framework for the market-led development of Sovereign Bond-Backed Securities and by setting specifc criteria for SBBS to benefit from more lenient regulatory treatments.

Context

The demand for safe assets

According to Anna Gelpern and Erik F. Gerding,[1] safe assets is a catch-all term for financial contracts that market participants treat as if they were risk-free. These may include government debt, AAA[2] corporate debt, bank debt, and asset-backed securities,[3] among others.' The authors further note that '[m]aking a contract safe combines financial engineering and legal design to reduce risks to payoff. At the extreme, it is possible to reduce some risks to the point where they could be ignored, at least for some purposes. However, risk reduction is always relative – it never goes down to zero. A contract is labeled safe to attract buyers. An effective label dissuades market participants from acquiring additional information about the asset. Guarantees import safety from the outside, when issuer and contract attributes are not enough to secure risk-free treatment'.

Pierre-Olivier Gourinchas and Olivier Jeanne[4] note that safe assets 'provide a reliable store of value, serve as collateral in financial transactions, fulfill prudential requirements, and serve as a pricing benchmark'. The global financial crisis spurred demand for such assets. Thus, academics (e.g. Ricardo Caballero) and organisations (e.g. the International Monetary Fund) flagged the potential problem of a safe asset shortage, driven by the shrinking of the amount of assets perceived as safe (at the time, limited to high-quality sovereign debt) and the increased demand for such assets. Gourinchas and Jeanne note that, 'should they disappear, the argument goes, the danger is that the financial system itself might crumble: markets for collateralized transactions (repurchase agreements or "repos") would collapse; financial institutions would have difficulties meeting their prudential requirements, and the pricing and well-functioning of riskier segments of the financial system could be derailed altogether.'

1 Anna Gelpern and Erik F. Gerding, Inside Safe Assets. Yale Journal on Regulation. September 2016.
2 Meaning, of the highest credit quality. According to the Financial Times, credit ratings are 'opinions expressed on an alphanumeric scale on the relative ability and willingness of a debt issuer to meet financial commitments'. For more information on two of the main credit rating systems, see 'Moody's Rating System in Brief' and 'S&P Global Ratings Definitions'.
3 Securities whose collateral is composed either from mortgage loans (mortgage-backed securities – MBS) or from collections of other types of financial assets (non-mortgage securities). For more information, see A. Delivorias, 'Understanding Securitisation', EPRS, October 2015.
4 Pierre-Olivier Gourinchas and Olivier Jeanne, Global safe assets, BIS Working Papers, No 399, Monetary and Economic Department, December 2012.

Sovereign bonds and sovereign-bank nexus

Sovereign bonds are bonds issued by governments. They can be denominated either in the country's local currency or in a foreign currency. A recent report by the Association for Financial Markets in Europe can help to give a sense of their magnitude: EU treasury bills issuance in 2017 hovered around €1.25 trillion, while EU government bonds followed closely at €1.23 trillion. Of this bonds and bills issuance, the major part is concentrated in euro area countries, where last year's issues bonds and bills equal to €1.9 trillion, while issuance in non-euro area countries was at €0.5 trillion.

The term 'sovereign-bank nexus' (or loop) is used to describe the link between the creditworthiness of a country's government and that of its banks. According to Markus K. Brunnermeier *et al.*,[5] the deterioration of sovereign creditworthiness in Greece, Ireland, Italy, Portugal and Spain during the sovereign debt crisis, reduced the market value of their domestic banks' holdings of domestic sovereign debt. The drop in value in turn reduced the perceived solvency of domestic banks and curtailed their lending activity. [6] The resulting bank distress increased the likelihood of their needing to be bailed out by their governments, which led to further sovereign distress, engendering a 'bailout loop'. In addition, the impact of the reduction of loans led to a drop in tax revenue, which also contributed to weakening government solvency in these countries, triggering a 'real-economy loop'.

Securitisation

Securitisation is part of structured finance. It is a financing technique by which homogeneous income-generating assets (e.g. loans) – which on their own may be difficult to trade – are pooled and sold to a specially created third party, which uses them as collateral to issue securities and sell them in financial markets.

According to Regulation (EU) 2017/2402, of 12 December 2017, 'securitisation' refers to a transaction or scheme[7], whereby the credit risk associated with an exposure (i.e. the potential loss) or a pool of exposures is tranched (i.e. divided into slices) and:

- payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;
- the subordination (i.e. the order of priority in claims) of the tranches determines the distribution of losses during the ongoing life of the transaction or scheme;
- the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013.[8]

5 Markus K. Brunnermeier et al, Working Paper 21993, National Bureau of Economic Research, Cambridge, USA, February 2016.
6 Here, see also Nicola Gennaioli, Alberto Martin and Stefano Rossi, 'Banks, government Bonds, and Default: What do the data Say?', Journal of Monetary Economics (2018).
7 For more information on securitisation schemes, see A. Delivorias, 'Understanding Securitisation' and 'Synthetic securitisation', EPRS, 2015 and 2016 respectively.
8 i.e. (a) the exposure is to an entity which was created specifically to finance or operate physical assets or is an economically comparable exposure; (b) the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; (c) the primary source of repayment of the obligation is the income generated by the assets being

Sovereign bond-backed securities

The SBBS concept, which does not yet exist in practice, was initially considered in September 2011, followed by the proposal by a group of economists[9] in 2016 and 2017[10] to create European Safe Bonds (ESBies). They believed that the euro crisis was fuelled by the aforementioned 'diabolic loop' between sovereign and bank risk, coupled with cross-border 'flight-to-safety' capital flows, and that the ESBies, would help to resolve these problems. In the words of the economists, ESBies, in one sentence, are 'securities issued by a European Debt Agency (EDA) composed of the senior tranche on a portfolio of sovereign bonds issued by EU Member States, held by that agency and potentially further guaranteed through a credit enhancement'. These bonds, freely traded in markets, would be considered safe – as their design would aim at minimising the risk of default, they would be issued in euros and they would benefit from the European Central Bank's commitment to keep inflation rates below, but close to, 2 % – and liquid, as they would be issued in large volumes and serve as safe haven for investors seeking a negative correlation with other yields. And last but not least, they would not require any form of fiscal solidarity among euro area governments, given that each Member State's government would remain entirely responsible for its own solvency.

According to the Commission's legislative proposal, which is based on the suggested creation of ESBies mentioned above, SBBS would consist of a diversified pool of euro-area sovereign bonds, according to their economic weight. When buying SBBS backed by that pool, investors would be able to choose whether to buy the higher or the lower risk securities, depending on their risk appetite. The highest-risk securities would be first in line to bear any losses on the underlying pool, should such losses arise, but, in exchange, would pay investors a higher return. The senior securities, would be low(er)-risk, as they would bear losses only after the highest-risk securities were fully wiped-out. By design, SBBSies would not involve any mutualisation of risks and losses among euro area Member States. They would be put together by private sector bodies created solely to issue and manage these instruments. Then, the private sector entity would assemble an underlying portfolio of sovereign bonds from the market and would subsequently transfer them to a legally separate, self-standing entity, specifically set up for the sole purpose of issuing to investors a series of securities representing claims on the proceeds from this underlying portfolio.

Existing situation

As explained above, the idea behind the creation of sovereign bond-backed securities is fairly recent and SBBS do not yet exist in practice. There is therefore no existing legislation regulating this kind of instrument at European level.

The closest financial instrument to SBBS would be securitised products. Nevertheless, if SBBS were to be treated under the the current European framework for securitisations, there would be the paradox that investing in them would carry higher charges than investing directly in euro area sovereign bonds. Indeed, under the current regulatory framework, banks do not need to hold any capital against their investment in

financed, rather than the independent capacity of a broader commercial enterprise.

9 Namely Markus K. Brunnermeier, Luis Garicano, Philip R. Lane, Marco Pagano, Ricardo Reis, Tano Santos, David Thesmar, Stijn Van Nieuwerburgh and Dimitri Vayanos.

10 Markus K. Brunnermeier Sam Langfield Marco Pagano Ricardo Reis Stijn Van Nieuwerburgh Dimitri Vayanos, 'ESBies: safety in the tranches', Economic Policy, Volume 32, Issue 90, 1 April 2017.

these sovereign bonds, whereas they have to abide by specific capital requirements if they hold securitised products (to counterweight, among other things, moral risk or the realisation of unpredictable losses).

The Commission notes, however, that SBBS are different, in this respect, from securitisations. First of all, they are less complex than securitisations, as their underlying pool is simpler and more transparent. Also, high capital requirements would constitute challenges to the creation of the market for SBBSs. It therefore considers that regulatory charges, which make sense in the case of securitisation, are not justified for sovereign bond-backed securities.

Parliament's starting position

ESBies are not the only academic proposal that has been made with a view to solving the euro-area crisis – many more were published during the crisis, involving commonly issued securities for the euro area, in one form or another. Three that stood out among them were the proposals for Eurobills (by Thomas Philippon and Christian Hellwig), for Blue/Red Bonds (by MEP Jakob von Weizsäcker and Jacques Delpla) and for the European Redemption Pact (by the German Council of Economic Experts). According to Stijn Claessens et al these proposals all aimed at three main goals: circumventing the flight of investors from weak to strong sovereigns; weakening the tie between a sovereign and its local banks; and generating liquidity and cost advantages through a deeper market with larger debt volumes.

Already in its July 2011 resolution 'Financial, economic and social crisis: measures and initiatives to be taken', the European Parliament called on the Commission to carry out an investigation 'into a future system of Eurobonds', pointing out that Eurobonds 'would offer a viable alternative to the US dollar bond market, and that they could foster integration of the European sovereign debt market, lower borrowing costs, increase liquidity, budgetary discipline and compliance with the Stability and Growth Pact (SGP), promote coordinated structural reforms, and make capital markets more stable'.

Later that year, the Commission grouped the aforementioned proposals in a green paper, in which it examined the feasibility of 'stability bonds', i.e. sovereign bonds issued in common among euro area Member States. Noting the significant benefits, but also challenges involved with their introduction, the Commission grouped the options for common issuance into three approaches, presenting their trade-offs, the necessary changes in the existing fiscal framework and various implementation issues.

Parliament considered the feasibility of this particular proposal, through an own-initiative resolution adopted in January 2013. While stressing that all existing and future instruments that are part of the economic governance framework of the EU need to be democratically legitimised, it welcomed as beneficial the prospect of common bonds. It therefore called on the Commission to present a report to Parliament and Council examining the options for a roadmap towards common issuance of public debt instruments, paying particular attention to the feasibility of introducing a redemption fund. It also called on Member States to consider the introduction of short-term debt in the form of Eurobills, as well as 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. In addition, it noted that a system of partial substitution of national issuance (such as the blue/red bonds) might have significant benefits.

Parliament further asked the Commission to clarify the legal restraints to the common issuance of bonds, especially Article 125 of the Treaty on the Functioning of the EU and its implications for issuance with joint liability, several liability, and joint and several liability.

Finally, it considered it the establishment of a roadmap towards the common issuance of public debt instruments to be essential. It therefore proposed one, with four main steps: the first step involved immediate measures to exit the crisis and included the setting up of a temporary European redemption fund and the introduction of eurobills in order to protect Member States from illiquidity runs; the second one involved the introduction of blue bonds (without Treaty change), safeguarded by national debt brakes or other mechanisms to avoid moral hazard; the third, the common issuance of national debt (with Treaty change); and the last step, the issuance of 'genuine European debt in conjunction with an enhanced European budget' (also with Treaty change) to finance EU investments for EU public goods, such as infrastructure, or research and development.

Proposal

Preparation of the proposal

In mid-2016, the European Systemic Risk Board (ESRB) established a high-level task force on safe assets, chaired by the Governor of the Central Bank of Ireland, to investigate the practical considerations relating to SBBS. The task force ran a dedicated industry workshop in Paris in November 2016, conducted a public survey/questionnaire on the ESRB website in December 2016 and held a workshop in Dublin on 20 October 2017, to gather the views of the public debt managers (DMOs). In its January 2018 report, the task force concluded that a market for SBBSs can develop under certain conditions.

The potential of SBBS was also highlighted in President Juncker's letter of intent on the occasion of the September 2017 State of the Union address and in the October 2017 Banking Union communication, both of which committed the Commission to take action in this area.

The Commission followed through, launching an inception impact assessment with a feedback deadline of 20 February 2018. Its impact assessment accompanying the proposal received a positive opinion with reservations from the Regulatory Scrutiny Board on 16 February 2018. For a summary of the main points of the impact assessement and an initial appraisal of its strengths and weaknesses, please see the forthcoming EPRS initial appraisal.

The changes the proposal would bring

The Commission proposal contains four parts. The first part provides a set of rules that define the constitutive elements of SBBSs. These rules are necessary to ensure that as standardised as possible product is produced by the markets. This in turn favours its liquidity and appeal to investors. The second part provides rules that define notification and transparency requirements for the issuing entity to ensure that self-attestation is performed in a harmonised and credible way. The third part contains rules regarding the supervision of SBBSs and possible sanctions in case of non-compliance and/or fraudulent behaviour of the issuing entity. The fourth part contains a set of amendments to the existing legal framework required to grant SBBSs a regulatory treatment in line with their unique design and properties.

Chapter 1 – subject matter, scope and definitions (articles 1-3)

The provisions in this chapter explain the subject matter (general framework for SBBS), scope (entities involved in the issuance and the holding of such instruments, such as original purchasers, special purpose entities (SPE), or investors) and the definitions used (such as sovereign bond, SBBS, investor, or tranche).

Chapter 2 – composition, maturity and structure of SBBSs (articles 4-8)

Article 4 provides that the underlying portfolio of SBBSs must only be composed of sovereign bonds of all EU Member States whose currency is the euro, and of the proceeds of their redemption.The Commission justifies this restriction as being necessary to ensure that none of the bonds in the underlying portfolio of SBBSs is affected by currency risk. In addition, the weight of the sovereign bonds of each Member State

within an SBBS portfolio will be equal to the relative weight of the respective Member State's participation in the ECB capital key.[11] The article further provides for the possibility of sovereign bonds of a Member State being excluded from the underlying portfolio of a SBBS, and sets the mode of determination of the baseline weights of the remaining bonds in the portfolio.

According to article 5 of the proposed regulation, SBBSs tranches that are part of the same issue, must have a single original maturity date. That date shall be equal to – or up to one day longer than – the remaining maturity of the sovereign bond with the longest remaining maturity within the underlying portfolio. Furthermore, the remaining maturity of any other bond in the portfolio should not be shorter than 6 months compared to the sovereign bond with the longest remaining maturity in the portfolio.

Article 6 provides that an SBBSs issue should be composed of a senior tranche and one or more subordinated tranches, intended to provide protection to the senior tranche. The outstanding nominal value of the senior tranche should be equal to 70 % of the outstanding nominal value of SBBSs issue (to ensure standardisation of this tranche across different issues).[12] However, when adverse developments dirsupt the functioning of sovereign bond markets in a Member State, and the Commission confirms the disruption, the SPEs will lower that outstanding nominal value to 60 % for any SBBS issued after the Commission confirmation. The number and outstanding nominal values of the subordinated tranches are to be determined by the SPE but, in order to limit the risk of the junior tranche (i.e. the the tranche bearing losses before any other tranche), its nominal value must be at least 2 % of the outstanding nominal value of the entire issue.

The European Securities and Markets Authority (ESMA) is tasked with monitoring whether the conditions for a change in the composition of the underlying portfolio or in the size of senior tranche exist, and with informing the Commission accordingly. The Commission may decide that such conditions exist or have ceased to exist by adopting an implementing act. Such an implementing act could only enter into force following a vote by Member States representatives in the European Securities Committee, in accordance with the examination procedure (see below, article 26(2)).

Payments (principal or interest) under an SBBS are dependent upon the payments of the underlying portfolio of sovereign bonds. Losses will be recognised and assigned as they materialise. The distribution of losses and the order of payments will be determined by the tranche of the SBBS issue and will be fixed for the entire life cycle of the SBBS issue.

To ensure that investors are protected from the risk of insolvency of the institution that acquires the sovereign bonds (original purchaser, typically a bank), article 7 sets obligations for SPEs – they must be established in the EU, their activities must be limited to issuing and servicing SBBS issues (and managing their underlying portfolios) and they are solely responsible for the provision of those services and activities. The SPEs will have full ownership of the underlying portolio of an SBBS issue.

11 The capital key is 'a proxy of each Member State's economic size and its stake in the stability of the European financial system'. The Commission also notes that 'Other keys have been considered but have been found to be inferior. For example, a key based on each Member State's outstanding sovereign debt could give rise to moral hazard, whereby a Member State may benefit more from the product if it increases its overall outstanding debt'.

12 The ESRB task force has shown by way of a comprehensive analysis that a 30 % thick subordinated tranche is sufficient to ensure low risk of default for the corresponding (ie. 70 % thick) senior tranche including in scenarios of market stress.

Furthemore, SPEs must keep records and accounts so that they segregate (a) their own assets and financial resources from those of the underlying portfolio of the SBBS issue (and related proceeds); (b) the underlying portfolios and proceeds of different SBBS issues; (c) the exposures held by different investors or intermediaries; and verify (d) that at any time the number of SBBSs of one issue is equal to the sum of the SBBSs held by all investors or intermediaries in that issue; and that the outstanding nominal value of the SBBSs of one issue is equal to the outstanding nominal value of the underlying portfolio of sovereign bonds of that issue.

Article 8 provides that payments from the sovereign bonds composing an SBBS portfolio which are due before payments from the SBBS itself must be invested by the SPEs only in cash or highly liquid financial instruments in euros. In addition, SPEs must not change the underlying portfolio of an SBBS until it comes to maturity.

Chapter 3 – Use of the designation 'SBBS' (article 9), and notification, transparancy and information requirements (articles 10-12)

To ensure the standardisation of SBBSs, the designation will only be used if (i) the product fulfils the requirements of articles 4-6 (substantive requirements) and (ii) ESMA has been notified in accordance with article 10 (notification requirements).

Article 10 sets out the notification requirements for SBBS. SPEs must notify ESMA, at least a week before SBBS issuance, that the issue meets the requirements of articles 4-6. ESMA is entrusted with maintaining a list on its website with notified SBBS issues, as well as with updating it (adding/removing issues). The article also establishes the obligation for competent authorities to notify ESMA if they impose remedial measures or administrative sanctions (see article 15).

Article 11 establishes transparency requirements. Under this article, SPEs must provide (make available on a website that meets specific standards), without undue delay, specific information on the portfolio, the payments, the main features of the SBBS[13] and the previous article's notification. According to the Commission proposal, this 'should allow investors to understand, assess and compare transactions in SBBSs and not to rely solely on third parties, such as credit rating agencies'.

Chapter 4 – product oversight (articles 13-20)

Article 13 of the proposal requires Member States to designate (one or more) competent authorities to supervise the compliance of SPEs with the regulation (each competent authority supervises those SPEs established in its Member State). Member States must ensure that competent authorities (CAs) have the necessary supervisory, investigatory and sanctioning powers to fulfil their duties (the article establishes minimum powers for CAs). In addition, Member States must inform ESMA and the Commission about those competent authorities.

13 Only in those cases where a prospectus has not been drawn up.

Given the cross-border nature of the SBBSs market, article 14 deals with the cooperation between Member States' competent authorities and ESMA. Moreover, the article highlights ESMA's role in ensuring supervisory convergence.

In case there are reasons to believe that an SPE, in infringement of article 9, has used the designation 'SBBS' to market a product that fails to comply with the necessary requirements, article 15 sets out a procedure, involving the national competent authority (which takes the decision), the other relevant competent authorities (which can disagree with it) and ESMA (where the matter is referred, in case the disagreement between competent authorities is not resolved).

To prevent abusive behaviour and to encourage trust in the product, appropriate administrative sanctions and remedial measures are provided under article 16 for situations where a product that is declared by an SPE to be an SBBS does not fulfil the necessary classification, notification or transparency requirements. The article provides that when determining the type and level of administrative sanctions, competent authorities must take into account relevant circumstances, as well as ensuring that the decision imposing the measures/sanctions is properly reasoned and subject to a right of appeal.

Member States must notify the Commission and ESMA about the laws, regulations and administrative provisions related to the implementation of supervisory and sanctioning obligations provided for in articles 13-16, as well as any subsequent amendments (article 20).

Article 17 concerns the interaction with criminal sanctions for certain infringements provided for under national law. The article provides that competent authorities should have the powers to transmit to ESMA and other competent authorities relevant information regarding criminal investigations and proceedings related to the infringement.

According to article 18, the competent authorities must publish on their website (and retain for five years) any decision imposing an administrative sanction imposed for an infringement, when there is no longer a right of appeal. The published decision must include information on the type and nature of the infringement, and the identity of the natural or legal person on whom the sanction has been imposed. The following paragraph, however, specifies that, under speficic circumstances, competent authorities will publish the decision on an anonymous basis.

Article 19 entrusts the European Systemic Risk Board (ESRB)with the macroprudential oversight of the EU SBBS market.

Implementing powers and final provisions (articles 21 to 24)

Articles 21 to 24 amend some articles of other legal acts, to ensure that in all financial sectors regulated at European level investments in SBBSs receive a regulatory treatment equivalent to the one given to euro area sovereign bonds. The amended acts are the undertakings for collective investment in transferable

securities (UCITS) Directive ((EU) 2009/65/EC),[14] the Capital Requirement Regulation ((EU) No 575/2013),[15] the institutions for occupational retirement provision Directive ((EU) 2016/2341) and the Solvency II Directive ((EU) 2009/138/EC).[16]

14 According to the Commission, the aim of amending the UCITS Directive is 'to ensure that when Member States authorise UCITS to invest up to 100% in transferrable securities issued or guaranteed by a public body, this exception is also granted to SBBSs'.
15 The Capital Requirement Regulation is amended to ensure that capital requirements and exposure limits for institutions holding SBBSs are the same as holding Member States' sovereign bonds directly.
16 The Commission proposes to amend Article 104 of the Solvency II Directive to ensure that for the purposes of the calculation of capital requirements, SBBSs are treated as Member States' central government and central banks denominated and funded in their domestic currency.

Views

Advisory committees

Neither the EESC nor the CoR has yet adopted an opinion on the subject.

National parliaments

The proposal is currently being examined by the Parliaments of six Member States. The deadline for the submission of reasoned opinions on the grounds of subsidiarity is 24 September 2018. At the time of writing, no Member State has submitted a reasoned opinion on the matter.

Stakeholders' views[17]

On 24 May 2018, Victoria Webster, Director of Fixed Income at the Association for Financial Markets in Europe (AFME), noted that 'In order for such instruments to be workable, more analysis by a variety of market participants is needed. We therefore encourage EU legislators to consider further consultations with Debt Management Offices, Primary Dealers and investors before deciding to progress this initiative further.'

Academic views

In a recent post in the Financial Times' *Alphaville*, Marcello Minenna raises some concerns over ESBies. First, he notes, the absence of joint liability in the issuance of those bonds means that the possibility of spreads widening again in times of stress still exists. Secondly, banks have asset return targets based on funding costs (and not on financial stability). This implies that, if they invest in low-yielding ESBies, they will seeks to compensate the loss in yield elsewhere – probably by buying riskier tranches of ESBies. As a result, ESBies may simply reproduce the current segmentation of government bonds (core-periphery). Lastly, given that the amounts of government bonds to be securitised would be based on the debt-to-GDP ratio or the ECB's capital key, there would be differences in which countries bonds would be included, potentially creating problems for peripheral countries.[18] Indeed, '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'.

In a recent VOXeu article, Paul De Grauwe and Yuemei Ji express their concerns over whether ESB-type assets can be an instrument for dealing with systemic risks in times of crisis. In their view, the fact that

17 This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.

18 The author argues that this would nearly eliminate the secondary market for some sovereign issuers while altering the relative availability of the bonds of the remaining issuers.

the creation of a safe asset does not eliminate the national government bond markets implies that the potential for destabilising capital flows across the euro area will still be present; moreover, by contributing in markets for government bonds shrinking, such assets might increase volatility during crisis periods. In addition, the authors doubt whether in a period of crisis, the senior tranche of the asset will maintain its status of safe asset. Instead, investors are more likely to divest from these tranches, in order to invest in 'real' safe government bonds. The authors instead argue that real stabilisation of the euro area goes through two mechanisms: willingness of the ECB to provide liquidity in the sovereign bond markets of the euro area during times of crises through its outright Monetary Transactions (OMT) programme, and creating Eurobonds that are based on joint liability of the participating national governments, without which it will not be possible to create a common sovereign bond market.

In a Bruegel blog post, Gregory Claeys argues that while, in good times, it is possible that SBBS would help increase the stock of supply for safe assets and break the link between banks and sovereigns,[19] it is hard to imagine how they would provide a way for euro-area governments to maintain market access in times of crisis. First of all, he notes, the ESRB insists that sovereign bonds of countries losing market access will not be included in the pooling. This, in turn, could result in the creation of a variety of SBBS with different compositions, resulting in the lack of a homogenous market, lower liquidity, and less transparency. This complexity might impact them negatively in a financial crisis, charactised both by flights to safety but also, flights to simplicity. Instead, Claeys, refering to Ricardo J. Caballero et al., argues that, to play the role of safe assets, securities need to be information-insensitive, in the sense that safe assets can be transacted without much analysis or concern for adverse selection. The author also notes that the introduction of SBBS might have the – perverse – effect of changing the incentives of governments to default, and thus increasing the risk of default on European debts. In his view, this makes the use of historical data in simulations hard to justify. Instead, he proposes to make all euro area sovereign bonds safe again, by (i) ensuring that public finances in the euro area are sustainable[20] and (ii) reforming the European Stability Mechanism.

19 The author notes, however, that, even for those two objectives to be met, SBBS would need to be introduced on a massive scale, which would require significant regulatory changes so as to treat SBBS as a risk-free asset, while penalising the holding of individual sovereign bonds.

20 To achieve this, the author proposes –among other things– to improve current fiscal rules, so that Member States can adhere to sustainable fiscal policies, to complete the Banking Union (EDIS and Single Resolution Fund) and create a euro area stabilisation instrument to deal with large asymmetric shocks.

Legislative process

The legislative process is still at an early stage. Neither Parliament nor Council has yet issued any draft positions on the subject.

References

EP supporting Analysis

EPRS Initial Appraisal of the Commission's impact assessment (forthcoming).

Other sources

Link to Oeil to access all procedural documents: Sovereign bond-backed securities, European Parliament, Legislative Observatory (OEIL).

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