Speech by Sharon Bowles MEP to the Association for Financial Markets in Europe bond conference

Brussels: Friday 21st October 2011

“Well, I guess when the date of this conference was fixed you did not expect it to be at quite such a historic moment. I think you invited me to speak because I had been making a lot of noise about zero risk weighting of sovereign bonds in the domestic currency of a Member State - which I will get to later. I can also get to the agreement reached this week on short selling and the ban on naked sovereign CDS.

“But sovereign bonds have got a whole lot more interesting recently – unfortunately, rather more in the sense of the Chinese saying where to live in interesting times is a curse rather than a blessing. It is certainly the case that a lot more people watch and talk about European bond spreads than used to be the case - it is no longer just specialists.

“So here we are, on the eve - possibly - of the meeting of European finance ministers to be followed on Sunday by the European Council that will determine whether we can restore market confidence and begin to move forward out of the Eurozone crisis.

“Too little, too uncertain, too late, has of course been the story of the Eurozone crisis and the fear is that is how things may continue a little while longer. I am not blind to the local difficulties that ministers and leaders have in their own countries but my energy has been put into urging solutions even if, at times, that lands me in hot water.

“One of the issues I was most concerned about right from the start of the rescue programs was sustainability in interest rates being charged and I waged a long campaign against the nearly 3% extra premium charged over EFSF cost. As they put it in Ireland, that cost them the equivalent of building a new hospital every week. At the start of this year, when it seemed impossible to wean some countries off punishment of offenders, I suggested that the extra 3% should be regarded as returnable collateral, put in an escrow account to hedge

against default. Mario Monti dubbed these the 'Bowles Bond'. Happily, that put the interest rate matter on the agenda and eventually rates were reduced - but it was slow and not until the July 21st agreement.
"Of course, the other part of sustainability is whether the debt is too large to be serviced and paid off, which still remains one of the outstanding issues to be tackled again for Greece this weekend. The punitive interest rate saga showed just how far away from understanding sustainability our leaders were.

"Since the inception of the EFSF I have pressed for heavy weaponry, and pondered the absurdity of having what was tantamount to a reverse leverage by insisting on an AAA rating. Fretting about cost difference between AAA and AA while slapping on the 3% punitive interest charge seemed bizarre to say the least. The other absurdity was to require unanimity in the decision-making process.

"So, as we all unfortunately know the situation deteriorated and we got to July when I said it was the 'last chance saloon' – I meant it and I am still left wondering what comes after last chance - we are certainly living on borrowed time.

"The July package did have elements that were promising - as well as the reduction of interest rates there was the extension of the duration of debt and these were good steps. There was the voluntary private sector involvement, which I thought was not enough viewed in the round with the credit enhancement, and is being visited again we are led to believe. It was agreed to raise the firepower of the EFSF but it fell far short of what markets by then needed, so again that is to be revisited - or at least so we are hoping with the leading candidate being the first loss insurance scheme.

"Alongside all this we also had the bank stress tests which, from the Parliament side, we pretty unanimously thought too weak. All in all, the European Banking Authority did a good job in the face of adversity and push-back from some Member States and the Parliament backed them up when faced with criticism of 'overstepping their authority'.

“In the latest package of measures under discussion, bank recapitalisation is an integral plank. This is another measure the Parliament has been calling for for a long time, along with more general bank crisis resolution which we wanted in place at the same time as the supervisory authorities last year.

“The original understanding brokered with banks was that they would hold on to their Greeks debt so as not to make matters worse in the markets: some did, some did not. More recently it seems banks have been getting rid of a range of their sovereign bonds - which adds to the complexity of planning voluntary haircuts.

“There are a few other issues in the melting pot: Eurobonds, growth strategy and economic governance.

“On economic governance we recently passed the package of six legislative measures that tightened the Stability and Growth Pact, introduced surveillance for macroeconomic imbalances, new fining procedures, budgetary coordination, and monitoring with a requirement for independent oversight offices and professional independence of statisticians, along with a whole range of other steps. Again, more is to come. For example, the proposals put forward by President Barroso last week could herald several more pieces of legislation directed at budgetary control for program countries, and moves commonly called 'fiscal union' may progressively be agreed upon in the longer-term.

“The Barroso proposals also included a growth strategy, which is welcome.

“Eurobonds remain somewhere in the mix, but it is increasingly likely that this is a medium to long-term issue rather than 'now'. That is certainly my view in the context of a long-term common bond that takes advantage of the depth and liquidity that such a large market would have. It seems easier to design a bond that works when better times are restored, and can even discipline, and this probably should not be hamstrung by different characteristics of a bond that involves elements of rescue. Whether a second type of rescue bond can be found,

maybe of limited edition type, to deal with the near-term situation remains to be seen. Politically, it looks very difficult. Could we here reapply a variable interest rate and the collateral idea I had?
“The ECB has taken a range of measures, and as far as I can see any long-term stable solution will inevitably involve the ECB at the very least as an 'eminence grise'. There is no doubt their position is difficult and there are things that cannot be said, but ultimately actions speak louder than words. Even though the ECB may not have the easiest of decision making procedures, as an institution it has demonstrated the ability to take action and intervene in a time scale that fits the market.

“As I said earlier, we really are on borrowed time and the next time the leaders meet, even if everything cannot be nailed down completely, there has to be progress on all of the key elements - on Greece, on banks, and on defences via the EFSF. This is not a case of two out of three is good enough.

“In my view, in addition to all other elements under discussion, the issue of lowering the EFSF rating should be considered - allowing more than €440bn to be deployable, increased by any leverage mechanism that can be agreed. Of course, as usual, the boat may have been missed because now it will be feared that a rating change is related to the warning on the French rating, whereas the case I make is totally independent of that - and of course anything that spreads the base of the rescue mechanisms is, in any case, helpful rather than the opposite.

“So, as promised, to a few other things:

“Aside from the drama of end game before us, it became apparent through the Greek situation that not all bonds denominated in Euros were equal and, as well recognised now, bond spreads in the Eurozone were insufficient. I confess that it had always been a mystery to me why so many people always spoke about bond spreads as a bad thing – of course it did indicate that there was not convergence which was bad in policy terms, but I had always put store by market discipline as a way of preventing profligacy and a basic requirement for making the Euro work. Alas, what I had not realised then, because it was before my

ECON days and any knowledge of banking regulation, was that treating all sovereign bonds in the currency of a state as equal, with zero risk weight, both undermined market discipline and even provided a perverse incentive to hold those with higher interest rates.

“The basic assumption that a sovereign can print money, so there is no nominal risk, underlies the Basel assumption of zero risk weight and this is a false assumption for a monetary union. I am not the first to observe this – some warned about it at the onset of the Euro I have found out, but I have set about trying to change it in regulation.

“My first success was getting the point included in a European Parliament resolution in July last year that such zero rating is not always justified. Since then, I developed a proposal that adjustment of the risk weighting could be used as a tool of economic governance – it seemed to me that the market effect of the Commission giving a warning that the risk weighting would be adjusted if a Member State did not adhere to fiscal plans under the Stability and Growth Pact might be a rather more effective measure than fines.

“Again, the Parliament has supported such an approach in its six pack amendments, but it was just a bit too radical to get included in the final compromise with Council. However, it is the intention of many of us now to address the point as we do the Capital Requirements Regulation - it is Article 109.4. Andrea Enria of the EBA is among the growing band of those converted to the idea that it must be tackled, so the question now is more of when to implement and how, bearing in mind the procyclical effect it would have at the moment. A large exposure regime might be one way that is an alternative to changing risk weighting, and of course we could also involve the European Systemic Risk Board.

“A wider approach of the validity of zero risk was also talked about with the US downgrade, but of course the Eurozone crisis has distorted market response as the dollar is still seen as the safe haven.

“Sovereign debt is also very much at the heart of capital requirements - in banking, insurance and CCPs. It is more so as a consequence of the financial crisis and recognition of liquidity problems. However, the current situation shows how difficult it is to be certain of liquidity, and I also have a basic instinct that we now risk too much correlation between sectors and so I have a preference for diversity.

“Finally, I said I would say something about sovereign CDS. As you will know by now, earlier this week, we finally reached agreement with Council on the regulation containing the rules for banning naked sovereign CDS.

“I will not conceal that as far as I can see this ban idea had its origins in the world tour that Greek politicians did blaming naked CDS for their sovereign troubles, which was good value for getting column inches for any politician even though it was always known the numbers proving this did not add up. But some made profit out of Greece's misery, which sticks in the throat, and so an effort has been made to stop it.

“The rules will not take effect until 1st November next year - so maybe markets will be more stable than now - and there are safeguards. Proxy hedging using a CDS where there are correlated interests is allowed. And if there is any distress in the market, for example as shown by spreads or lowering of liquidity, then a Member State can opt-out of the ban. Review comes up quite quickly, in 2013, and by then there will be more data available, including that from the experiments that are ongoing at present. ESMA will of course be keeping a watching brief on all of this ready for the review and to give its opinion on the reasonableness of any opt-outs.

“So, as I said, we live in interesting times, where the world can be a little upside down from assessing risk by the usual rules. Indeed, CDS seem to be gaining importance both in Basle, where they get a better treatment than other hedges, and in the US where they are trying to legislate without ratings and have ended up looking at CDS.

“What does this mean when AAA France has 5 year CDS at 187 basis points and BB Philippines is only 190? A- Malaysia is 149 while Spain is 380 and Italy 452.

“So, at present, many think it is safer to be at risk of tsunami than to be in the Eurozone.

“Maybe that is right - EU leaders have missed all the sovereign tsunami early warnings - now the flood defences must be made high enough to stop engulfment and devastation.”

ENDS