European Safe Bonds (ESBies): Questions & Answers

The euro-nomics group[*]

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How do ESBies create value?

Value is created by providing a large supply of a safe debt security that banks can hold instead of risky sovereign debt, and thereby eliminating the distortions brought about by bad regulation. Current bank regulations and ECB practice of accepting all sovereign bonds as equal for open market operations and capital requirements, respectively, leads to a mispricing of sovereign bonds. They also induce banks to hold risky sovereign debt, generally issued by their national government, and therefore exposes them to sovereign credit risk. The resulting bank instability in turn raises doubts about government solvency, by reinforcing expectations of future bailouts. This perverse interaction between sovereign credit risk and bank instability can be removed by regulatory risk weights that induce banks to hold only ESBies in their portfolios, and by having the ECB accept only ESBies for liquidity provision.

ESBies also increase the "safe haven" premium and share it more evenly across Euro-area countries. They would command an even higher "safe haven" and liquidity premium than bunds, however, due to the extra safety and liquidity from pooling across European sovereigns. If the premium were as large as it is for U.S. Treasuries, then the revenues generated by issuing ESBies would be comparable to the revenues that Euro-area countries have obtained in seignorage from the euro. At least as importantly, this premium would now be shared with other countries that are as safe but not as liquid, like Austria, Finland, and the Netherlands, and with countries that are not safe at all, like Greece, Ireland, Italy, Portugal and Spain. ESBies will mitigate the large capital flow imbalances due to the search for "safe haven". The "flight to quality" would now be a shift out of the junior tranche and into the ESBies, rather than out of one European region and into another. This would stabilize portfolios for sovereign debt, and reduce the sudden reversals of capital flows across Europe and their associated relative-price distortions. With ESBies, the flight to safety across regions is replaced by a flight to safety across tranches.

[*] Euro-nomics is a group of concerned European economists, unaffiliated with any of their respective national governments. Their objective is to provide concrete, carefully considered, and politically feasible ideas to address the serious problems currently faced by the Eurozone. Their affiliations can be found at the end of the present document and on www.euro-nomics.com

Why does the market not create the ESBies?

A private entity could in principle buy and pool the different sovereign bonds but (1) the incentives would be to squeeze as much as possible from the senior tranche, compromising their safety; (2) it would face difficulties in removing the aforementioned distortions with respect to sovereign bonds; the change in regulatory risk weights and ECB practices is an essential part of the present proposal; and (3) the capital needed to develop a substantial and liquid market for ESBies seems beyond the capabilities of the private market at the moment; indeed, were policy makers to deem it necessary to further strengthen the ESBies with additional capital guarantees it is difficult to see how could the private market be able to provide such guarantees (Monoline insurers performed very poorly in the crisis). A private entity would not internalize the social benefits of our proposal and thus would bias the design away from what is socially optimal.

Does your proposal solve the sovereign crisis? If it were adopted, would the Euro problem disappear?

No. We believe it is an element of the solution, but it does not constitute the whole solution. We have two more proposals, for banks and for sovereigns, which we believe would put the Euro on a permanently solid footing. That said, we believe that the purchase of sovereign bonds by the EDA for the purpose of securitization could bring immediate interest rate relief to countries by offering a natural buyers for their bonds, and most importantly by offering markets a clear path out of the European debt crisis.

How much can my country (say Italy) borrow from the EDA? How much new debt can it issue? Can we return to the market without the ECB if the proposal is accepted?

We envision that ultimately 60% of Eurozone sovereign debt could be held by the EDA. This would amount to a steady state size of around 5.5 trillion euros. The system could be phased in gradually, over a five year period. Each six month period, approximately 550 billion euros would be structured. Each country would participate according to the size of its economy. Italy's weight, for example, would be 17%. That means that each year over a period of five years, the EDA would buy €188 billion of Italian debt. This would meet a substantial share of Italy's funding needs.

But is the crisis not a problem of competitiveness and of balance of payments—a macro crisis, as the International Monetary Fund's Head of Research Olivier Blanchard likes to say? How can a new financial instrument solve it?

The long-run insolvency of various Eurozone sovereign issuers (Greece, Italy, Portugal, Spain, etc.) is largely due to their low growth rates and the latter are in turn related to the long-run decline in their competitiveness. Addressing the sovereign solvency issue will therefore require addressing these long-run competitiveness issues. The ESBies cannot do that; they only address the short-term - but potentially explosive - problem created by lack of a safe asset for bank regulation and monetary policy, and by the perverse interaction between bank instability and sovereign risk in the Euro-area.

Should you not be thinking of the unsustainable positions of banks and countries?

Our proposal facilitates a way out of the sovereign crisis, but as mentioned is only part of the solution. Some countries are insolvent, and need to restructure their debt; similarly, some national banking systems face severe solvency issues. There are two more legs to our proposals that involve solutions to these two problems that we will release separately. Having said this, a significant fraction of the EDA's purchases of sovereign bonds could come directly from the banks, through a swap of sovereign bonds for ESBies. By the very introduction of the Esbie program, market prices on all sovereign bonds in the Eurozone will increase and so banks will receive a value for their bonds that is above the current market value. That said, the price banks receive for their sovereign bonds may be below the value at which they are recorded on their books, and thus banks may need to be recapitalized at the same time. In addition the Basel risk weights for sovereign bonds would be raised over a period of approximately five years, giving banks time to convert their existing portfolios of sovereign bonds into ESBies as well as rebuild their capital.

So let me understand: a hedge fund manager who would not touch Greek or Italian debt, is supposed to buy the junior tranche of the ESBies? Why?

He or she may want to do so because the junior tranche of the ESBies allows the fund to gain exposure to Italian sovereign credit risk by committing fewer resources than by buying directly Italian or Greek debt. Technically, the junior tranche of ESBies allows such an investor to gain substantial market exposure without using outright leverage (i.e. without borrowing). The junior tranche contains an embedded leverage. Compared to outright leverage investors who hold the junior tranche are not subject to margin calls.Hence, hedge funds should be willing to pay a premium for such a security as it provides the embedded leverage which is the driver of the hedge fund business.

We know regulatory agencies have done a bad job in the past. Who is going to determine the rating (or quality) of the debt of the different countries? How do we know what goes into the ESBie tranche? Are you not giving too much power to the ratings agencies again?

The design of ESBies will **not rely on ratings.** ESBies weights will be determined by a country's gross domestic product (GDP) according to some fixed, publicly available rule, not ratings. The tranching is designed to reduce the credit risk, and the potential credit enhancement, discussed in the full proposal, will reduce it even further.

This crisis started because securitization hid risk, and banks -- through financial architecture -- hid away all the information necessary for the economy to function. Will it really be solved by expanding even further the securitization process? Are we not going back to the beginning? Are we not trying to solve it by giving even more to those responsible for the crisis?

It is true that the opacity of securitization was responsible for many of the problems it generated. But the rules on which ESBies would be produced -- and therefore their internal composition – would be totally transparent and very easy to grasp. Moreover, the underlying sovereign debt securities from which ESBies would be manufactured will continue to be traded and priced on the market, in contrast with the mortgage loans that were packaged in mortgaged-backed securities. This adds to the transparency of ESBies, whose price will have to be aligned to that of their

constituent securities by arbitrage. Finally, ESBies would be designed and "produced" by a public agency of the Euro-area, not by private-sector intermediaries, and actively used by the ECB for its monetary policy. ESBies will provide the benefits of securitization without its "black magic" dangers. ESBies will be a conservative type of securitization based on fixed rules and not dependent on rating agencies' assessments.

One of the main mistakes made in the process of securitizing mortgages was the assumption that mortgages of different parts of a country could not all go bust at the same time. The structures assumed a correlation between the default risk of mortgages that was much too low, essentially saying that most of the default risk was idiosyncratic. In our proposal, we assume that most of the defaults will occur at the same time – in our analysis, defaults are highly systematic as opposed to idiosyncratic. Using extremely conservative assumptions about expected default rates for each country, we find that ESBies representing 70% of the underlying collateral pool would be very safe assets. They would have less default risk than German bonds! Details of these simulations are available in the detailed proposal.

Are you setting up a new Freddie Mac or Fannie Mae with this proposal?

No: Freddie and Fannie bought and securitized mortgages and guaranteed all the default risk on these mortgages. In our proposal, the credit risk in the underlying sovereign bonds is not borne by the securitizer (the EDA) but by private market participants -- the holders of the junior tranches. The EDA would make clear that these junior tranches are risky securities and that there would be be a guarantee on these junior securities. The full proposal discusses governance mechanisms that prevent bail-outs of the junior tranches in the event of default.

Aren't these just the Eurobonds that have been very much in the news?

No: a key difference with Eurobonds is that our proposal does not require a big transfer union between European countries the way Eurobonds would. A Eurobond is guaranteed jointly by all Eurozone taxpayers and thus creates a transfer union. In our proposal, the junior tranches that are held by the private market would absorb all the losses of a default in 99.2% of scenarios. Only in the event of a real catastrophe, would the ESBies be affected. A capital guarantee on the ESBies (not on the junior tranches!) could further reduce the risk of the ESBies. Such a capital guarantee would have to come out of a fund with capital paid in by the member nations, but pay-outs from this fund would only be triggered in extremely rare events. So instead of having a transfer union all the time, we propose a transfer union almost none of the time.

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