BACKGROUND DOCUMENT

Survey on sovereign bond-backed securities

European Systemic Risk Board
High-Level Task Force on Safe Assets

22 December 2016

Disclaimer

This background document of the European Systemic Risk Board (ESRB) sets out the current approach taken by the ESRB's High-Level Task Force on Safe Assets with respect to sovereign bond-backed securities (SBSs). It has been published to accompany the ESRB's survey of stakeholders' views of SBSs. The document does not constitute a final policy position or proposal by the ESRB. Responses to the survey will provide important guidance when preparing any policy position deemed appropriate.

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1. Rationale and audience of the survey

This background document sets out the context of a survey on sovereign bond-backed securities (SBSs). The purpose of the survey is to inform the ESRB's High-Level Task Force on Safe Assets, the creation of which was announced on 29 September 2016.[1] The mandate of the Task Force is to investigate the potential creation of SBSs, which could comprise senior and junior claims on a diversified portfolio of government bonds. The background document sets out the general features of SBSs, and provides the context for specific questions regarding their design and their implications for government bond markets.

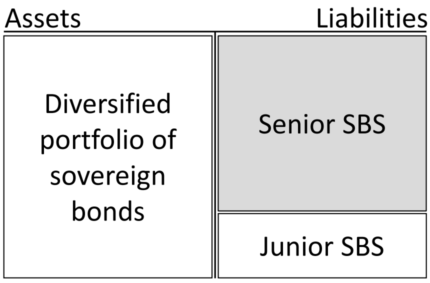
The survey is chiefly aimed at primary dealers in government bond markets, investors and traders in government bonds, and credit rating agencies. Responses are also welcome from public authorities, industry associations, research institutions, policy think-tanks, civil society organisations, other non-governmental organisations, and the general public.

2. Basic characteristics of SBSs

To create SBSs, a special vehicle would finance a diversified portfolio of government bonds with senior and junior claims on that portfolio (see Figure 1).

SBSs would therefore be issued in tranches, with junior SBSs first in line to take any losses that might arise in the event of a sovereign default. With an appropriate tranching point, senior SBSs could constitute liquid and low-risk assets with a senior claim on government bonds from across Europe.[2] Importantly, this could be achieved without any fiscal transfers or risk-sharing: governments would remain responsible for servicing their own debt instruments, which would still be issued at market prices. This would exert discipline on borrowing decisions.

Figure 1: Balance sheet of a special vehicle issuing SBSs



[1] See press release: https://www.esrb.europa.eu/news/pr/date/2016/html/pr160929.en.html
[2] Further design considerations regarding Sovereign-Bond Backed Securities are set out in Euronomics (2011), available at http://personal.lse.ac.uk/vayanos/Euronomics/ESBies.pdf; and ESRB Working Paper No. 21, available at https://www.esrb.europa.eu/pub/pdf/wp/esrbwp21.en.pdf?78c259326d82ec15a0918ffd5a094373. These papers provide much of the intellectual foundation for the work of the ESRB's High-Level Task Force on Safe Assets. However, they are published under the authors' responsibility; the ESRB does not necessarily endorse any particular claim or policy proposal they may contain.

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3. Rationale for the creation of SBSs

The creation of SBSs is inspired by two key policy objectives: namely, to reduce systemic risk and mitigate financial fragmentation.

i. *SBSs would reduce systemic risk* by allowing banks, insurers and other investors to diversify their government bond portfolios at relatively low transaction costs. Greater diversification is welcome insofar as concentrated portfolios provide a risk transmission mechanism between sovereigns and financial institutions.[3]

ii. *SBSs would mitigate financial fragmentation* by allowing all participating countries to contribute to the supply of low-risk euro assets. At present, low-risk euro assets are supplied asymmetrically, thereby inducing flight-to-safety capital flows across Member States during periods of stress.[4]

4. Design of SBSs

The ESRB High-Level Task Force's main job is to assess the feasibility of SBSs. This raises various technical questions related to the design of SBSs and the implications of design choices for the functioning of government bond markets. The key design questions are listed here.

i. *Who should arrange and service the special vehicle?* Several options are possible, including a public-sector entity, a group of private-sector entities, or a public-private partnership. Regardless of the identity of the arranger(s), the special vehicle(s) would be bankruptcy-remote.

ii. *Which countries should be included?* As a general principle, the underlying portfolio should include all euro area countries. In addition, non-euro Member States of the European Union could voluntarily opt in to the arrangement, particularly if they were to issue euro-denominated public debt.

iii. *What portfolio weights should be assigned to government bonds?* As a general principle, the underlying portfolio should be diversified. This could be achieved by applying weights according to countries' contributions to the ECB's capital key, possibly with marginal adjustments to accommodate small stocks of public debt in some countries (as in the Eurosystem's public sector purchase programme), since price discovery should continue to be a feature of government debt markets.

iv. *Which categories of government debt instruments should be included?* The task force's working hypothesis is that the underlying portfolio should comprise central government debt securities.

v. *On which markets should central government bonds be purchased by the special vehicle?* The vehicle could operate on the primary or secondary markets, or a combination of both. Purchases would be facilitated by coordinated issuance in primary markets.

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[3] See, for example, the ESRB report on the regulatory treatment of sovereign exposures (2015), available at http://www.esrb.europa.eu/pub/pdf/other/esrbreportregulatorytreatmentsovereignexposures032015.en.pdf?c0cad80cf39a74e20d9d5947c7390df1

[4] See, for example, Lane (2013), available at http://ec.europa.eu/economy_finance/publications/economic_paper/2013/pdf/ecp497_en.pdf

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vi. *What should be the size of the SBS market?* The ultimate size of such a market depends on the success of the scheme at its inception and the extent to which it affects liquidity in the underlying government bond markets. Preliminary analysis by the ESRB task force points to an initial upper limit on the size of the SBS market of approximately €1.5tn. At this level, SBS special vehicles would hold no more than 33% of any state's outstanding central government debt securities (analogous to a similar rule in the Eurosystem's public sector purchase programme), with only minor weight adjustments for countries with small stocks of public debt.

vii. *What should be the tranching point separating Junior from Senior SBS?* As a benchmark, numerical simulations suggest that the 30%-thick junior SBS would allow the 70%-thick senior SBS to be perceived as low-risk by financial markets. The task force is conducting further work to "stress test" this 30% tranching point.

viii. *Should junior SBSs be sub-tranched?* In principle, yes. Sub-traching would create a first-loss equity tranche and a mezzanine tranche. In this way, the securitization can cater to investors' heterogeneous risk preferences, thereby expanding the investor base.

ix. *Should junior SBSs receive credit enhancement?* The task force's working hypothesis is that the special vehicle would not need to be financed by any external equity. However, retention by the vehicle of any excess spread (owing to higher yields on the asset side than on the liability side) could provide some self-generating credit enhancement. The underlying portfolio would otherwise be entirely financed by junior and senior SBSs.

5. Survey

The purpose of the survey is to solicit views regarding sovereign bond-backed securities (SBSs), as set out in this background document. There are four categories in the survey: Senior SBS; Junior SBS; regulation; and the economics of issuing SBSs. Within each category, the survey poses several questions, which allow for "single choice" (from a list), "multiple choice" or "free text" responses. Each question is optional and may be skipped.

The survey begins by asking for information regarding the identity of the responding institution or person. These questions are optional; anonymised responses to the survey are welcome. After the survey period closes on 27 January 2017, information will be retained within the ESRB. Individual responses to the survey will not be published, but some aggregate insights might be disclosed.

Please return to the ESRB website to complete the survey by midnight CET on 27 January 2017.