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Analysis. Capital markets

Europe weighs potential 'doom loop' solution

Sovereign securitisation aims to unshackle peripheral banks as critics warn of shifting risks

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Ten years ago exotic credit instruments were at the heart of what seemed like financial Armageddon. This time round, the financial engineering techniques used to create them are seen by some as the solution to a particularly European problem.

In recent years European safe bonds, or ESBies, which lean heavily on the framework of the securitisation industry, have gained traction among European policymakers.

ESBies, which aim to make the continent's financial system safer, involve taking sovereign bonds from various countries and packaging them into bonds that would then be assigned a level of risk. The approach echoes the structuring of collateralised debt obligations in the years leading up to 2008.

The perceived benefit of ESBies is that they break the "doom loop" between banking sectors in the eurozone's periphery and those countries' government bonds by providing banks with an alternative safe asset.

During the eurozone crisis, weakness in peripheral banks spilled over into sovereign borrowing costs, and vice versa, because of the sector's high exposure to domestic debt.

"The social benefits would be making the system a lot less risky," says Gianluca Salford, a strategist at JPMorgan. "We will never end up in a situation where if Greece goes belly-up the Greek banks are totally bankrupt — this is the overarching theme."

It is also a way of bringing European sovereign debt markets closer to each other without explicit "mutualisation", where debt is issued collectively, an idea that has proved politically toxic in Germany in particular.

ESBies were first proposed by a group of European economists in 2011. This

May a European Commission paper advocated the creation of a market for the debt, with bonds carrying varying levels of risk.

However, the creation of the asset class faces significant hurdles, with market participants and observers raising a series of objections.

ESBies "would give a signal to the market that the eurozone accepts two different interest rate term structures", says Marcello Minenna at Consob, the Italian securities regulator. He adds that any bonds not included in the structures

"would become junk bonds" and therefore be harder to refinance.

Some strategists argue that although the process is designed in part to address peripheral banks' ownership of domestic assets, replacing holdings of higher yielding sovereign debt with a safe bond would damage profitability.

"The idea on ESBies is quite weak," says Michael Spies at Citi. "It will not minimise the risks of the next European sovereign debt crisis.

"In fact it can be quite dangerous for peripheral banks: if peripheral banks were forced to buy into ESBies because of amended regulation, it would mean their capital returns would suffer."

A critical factor in deciding demand for sovereign bonds is risk weightings, which determine how much capital a bank needs against its investments in different kinds of asset.

Sovereign bonds in Europe have benefited from a zero risk weighting, making them highly attractive to banks, many of which borrowed cheaply from the European Central Bank to buy sovereign debt after the crisis.

The securitisation process used to create ESBies would result in several tranches of debt, with the most senior carrying the lowest risk. However, it is unclear what weightings would apply to riskier tranches, and who would buy them, especially if the weightings were higher than for outstanding peripheral sovereign bonds.

"The junior tranche, by construction, is being created in such a way that will not be appealing to banks or insurance

companies," says Mr Salford.

If risk weightings are introduced for outstanding sovereign debt, as both the ECB and the commission have said they are considering, the scheme could make more sense, he adds.

Perhaps the greatest impediment to ESBies is political. The proposal has the backing of some European policymakers. According to Klaus Regling, managing director of the European Stability Mechanism, the scheme would be "a huge step forwards".

Jens Weidmann, president of the Bundesbank, is among those who are more cautious.

Indeed, despite the efforts to distance the plan from the concept of debt mutualisation, Germany is likely to regard the scheme with suspicion, according to Christian Odendahl, chief economist at the Centre for European Reform, a think-tank.

"The Germans feel that this is a clever way of persuading them to sign up to something which at least has the potential to become debt mutualisation by the back door," he says.

"Particularly if there was an agency doing the structuring and sales of these products, the markets would perceive that as 100 per cent safe and expect a bailout if it goes wrong."

Beyond the implications for the sovereign debt market, the very emergence of the discussion is seen as a boon for Europe's securitisation industry, which has yet to fully emerge from its post-crisis slump.

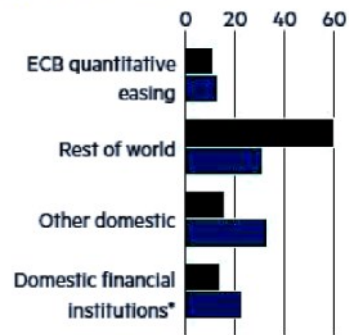
"It might seem a bit paradoxical," says Mr Salford. "Many people blame securitisation for the problems you had 10 years ago, and now it could become a source of stability. Securitisation is not an innately bad thing — it can be used well as a stabilising source.

"There is a sovereign risk, and in an ideal world you would transport sovereign risk to a place where it's more manageable."

Ownership of countries' debt

By type of owner (%)

■ France and Germany
■ Italy and Spain



10-year government bonds

Yield (%)



* Including central bank

Sources: JPMorgan; Thomson Reuters Datastream