

European Safe Bonds (ESBies): Executive Summary

The euro-nomics group^{*}

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

September 2011

Motivation

The world has a growing need for safe assets. The financial crisis of 2007-08 showed that financial markets can be enormously volatile as investors migrate from one asset to another in search of safety. But **Europe's fragmented sovereign debt markets cannot offer the quantity of safe assets that financial institutions demand and thus cannot effectively compete with U.S. Treasuries, which benefit from a U.S. consolidated market.**

This situation led to **two severe problems**. **First**, it created a **diabolic loop European financial systems and states**. An important source of the fiscal problems affecting many European states is the perceived need by the market to back up weakened national banking systems. In turn European banks are in distress because they hold large quantities of debt from sovereigns facing challenging fiscal outlooks. This situation has multiple origins but essentially banks have incentives to hold sovereign debt as it offers clear regulatory advantages, and it is in turn beneficial for governments to fund themselves through their own national banking system. Removing the perverse incentives that tie banks and sovereigns in this diabolic loop is essential to remove a **key source of contagion**. Breaking the loop requires removing the distortion at its root: sovereign bonds must be assigned both capital risk weights and haircuts for discount operations with the European Central Bank (ECB) that reflect the risks they represent both to the banks and the ECB.

The **second** severe problem is that, in the absence of a European safe bond, the bonds of some sovereigns at Europe's center have satisfied the demand for safe assets. In times of crisis, capital flows from the periphery to the center; in boom phases, capital flows from the periphery to the center. These alternating capital flows between searching for "yield" and searching for "safe haven", generate **large capital account imbalances in the Euro area**, with associated changes in relative prices and potential disruptions in asset markets.

^{*} 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

The proposal

To address these three shortcomings in the design of the Eurozone, we propose a two-pronged approach: (i) redesign bank regulation and ECB policy so that both will take into account the risk of sovereign bonds, and (ii) supply a large amount of euro-wide bonds as close as possible to being risk-free, that is, the creation of **European Safe Bonds (ESB)**, which we will refer to as **ESBies** for short. These new instruments would be *European*, being issued by a newly developed European Debt Agency (EDA) in accordance with existing European Treaties, and would not require more fiscal integration than that already in place. They would be *Safe* being designed to minimize default risk, issued in euros and benefiting from the ECB's anti-inflation commitment; they would be liquid as they would be issued in large volumes and serve as safe haven for investors seeking a negative correlation with other yields. They would be *Bonds*, freely traded in markets, and held by banks, investors and central banks to satisfy the demand for safe assets described above.

How would ESBies work? A new European Debt Agency would buy the sovereign bonds of member nations according to the relative size of the different member States. The EDA would passively hold these bonds as assets in its balance sheet, and use them as collateral to issue two securities. The first security, the ESBies, would be a senior claim on the payments from the sovereign bonds held in the portfolio. The second security would have a junior claim on these payments -- that is, it would be first in line to absorb whatever loss is realized in the pool of sovereign bonds that serve as collateral for these issues. That is, any failure by a sovereign state to honor in full its debts would be absorbed by the holders of the junior tranche security, not by the EDA, any Eurozone entity or the European Union. Both tranches -- ESBies and the junior tranche -- would be sold to willing investors in the market. Investors who want to hedge (or even speculate) on the ability of European member states to pay their debt would derive substantial benefits from trading these junior tranches. Investors seeking a safe asset denominated in a stable currency would benefit from holding ESBies.

The ESBies would be the preferential holding of banks and the preferential tool for monetary policy by the ECB. The ECB would grant strict preferential treatment to ESBies, accepting them as its main form of collateral in repurchase (repo) transactions and discounting operations. Because of the fixed weights in the ESBies, this would be consistent with conventional monetary policy, where open market operations would trade money for the safe ESBies without the ECB incurring credit risk or having large changes in the composition of its balance sheet. Second, banking regulators, including Basel, would give the ESBies a zero risk weight but would not do so automatically to other sovereign bonds. Some may deserve it, but others may not, and their risk weight should be attributed in a similar way to corporate bonds, depending on the default risk of the respective country.

Advantages of our proposal

Some benefits of our proposal stem from changes in bank regulation and ECB policy; others stem from the introduction of ESBies, and still others from the interaction of the two.

1. **Our proposal would eliminate distortions in sovereign debt markets.** Changing bank regulation so as to assign appropriate risk weights and ECB haircuts to sovereign bonds would eliminate the present mispricing of European sovereign bonds. Currently, the riskiest sovereign bonds have artificially low yields, because the risk weights according to Basel are zero for all sovereign bonds held by national banks, favoring these bonds relative to other risky investments. Moreover, in booms banks expect to be able to pass to the ECB sovereign bonds at generous haircuts during crisis. The regulatory changes that we propose would remove these distortions in sovereign bond pricing, and prevent the contagion provoked by the loop between sovereigns and banks both within countries and across borders.
2. **ESBies increase the supply of safe assets.** The change in regulation just described would only be fully effective if banks have an alternative safe asset to hold. Otherwise, banks would be confined to holding only the safest European national bonds (e.g., German). Instead, ESBies would satisfy the demand for safe assets from banks moving away from sovereign bonds. Because ESBies are a claim to the safest portion of the cash flow generated by a well-diversified portfolio of bonds, banks could avoid the overexposure to national bonds that is at the heart of the diabolic loop between sovereign and banking crises.
3. **ESBies increase the safe haven premium and share it across Euro-area countries.** The EDA would capture some of the “safe haven” premium that investors are willing to pay in exchange for safety and liquidity, which is currently mostly captured by Germany. ESBies 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.
4. **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.
5. **Monetary policy conduct will also benefit:** the ECB will be able to effect open market operations with ESBies. Conventional monetary policy requires that money be traded for bonds that are safe, and the ESBies would be the closest there is to such an asset. The ECB would still be able to conduct unconventional monetary policy if desired, by trading ESBies for other riskier securities.
6. **ESBies are not Eurobonds.**
 - Our proposal does not appeal to the taxing power of any sovereign over its citizens. The safety of the ESBies is achieved by the triple virtues of diversification, tranching, and credit enhancement. It does not rely on any particular government to extract

resources by taxation. Related, there are no fiscal transfers between regions of Europe as a result of the ESBies. Indeed, although ESBies would provide some relief from the sovereign debt woes of Euro-area countries, the EDA will generally buy an amount of sovereign bonds that is well below the total. As a result, the marginal bond issued would still have to be placed in the private market and be correctly priced. National governments would thus receive the right signals from market prices to provide them the right incentives in managing their public finances.

- Hence this proposal requires, to our knowledge, no change to European Treaties. Nothing in the Treaties forbids the creation of ESBies, and the EDA's mission would fall into the broad mandate that was given to the EFSF. The bank regulation revision favoring ESBies would come naturally in a fast-tracked revision of the Basel standards. Finally, the charters of the ECB could be easily modified to encourage it to buy ESBies and stop having to accept all sovereign bonds of member states without violating the spirit of the European Treaties. This is in contrast to Eurobonds, which involve a complicated, multi-year, treaty amendment process.
7. A final advantage is that, since ESBies would be issued at different maturities, they would generate as a by-product the **establishment of a true euro yield curve** that can serve as reference for a variety of pricing and hedging needs, which is currently missing in Europe.