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EU needs a bigger toolbox to safeguard bond market

By Michael Heise

The completion of Greece's financial rescue programme this summer marked the end of the eurozone crisis. At least those were the hopes of European policymakers. Reality, however, is less forgiving. The confrontation between Italy and the EU Commission over fiscal rules has shown that the eurozone remains vulnerable to bond market breakdowns.

Although the eurozone has undergone institutional reforms, such as the establishment of the European Stability Mechanism (ESM), a body made up of eurozone countries that helps any member in financial distress, and the banking union (though incomplete), major deficiencies remain. Sovereign debt is still too high in too many places, and banks are laden with bad loans.

The European Central Bank, with its unconventional monetary policies, has been a big line of defence against market turbulence. But the days of unconventional measures are numbered — and with the normalisation of monetary policy the era of suppressed volatility might end too. Without the ECB's safety net, financial stress could easily trigger severe bond market dislocations in the eurozone, with severe consequences for the real economy.

Hence the lively discussion about how to build up new defences against the next shock. Many ideas on the table involve the creation of new classes of government bonds that incorporate some risk sharing between countries. Yet "creditor" countries have not shown any willingness to accept further significant debt mutualisation and "debtor" countries do not want to forfeit any sovereignty by being subjected to reform and austerity programmes. Given the populistic backlash in many eurozone countries, a successful replay of past rescue plans cannot be relied upon in the future.

An idea that may be capable of preventing or at least mitigating bond market dislocations is a European bond insurance scheme. The concept of sovereign insurance avoids most of the problems encountered by other rescue tools. It avoids the heavy political burden of debt mutualisation and austerity regimes, actively encourages private sector lending and reduces contagion between sovereign debtors.

How would it work? The easiest way would be to expand the toolbox of the ESM. It would function as a bond insurer in which it would offer a partial guarantee for eligible sovereign bonds and thereby partially protect investors against potential haircuts. Countries wishing to make use of this guarantee would have to pay a pre-determined fee for the guaranteed amount.

The insurance scheme also has other advantages for eurozone countries. The firepower of the ESM would be strongly enhanced as the concept ensures that private investors keep their skin in the game in difficult market situations. By contrast — the other option in which the ESM grants loans or buys bonds of a country when private investors reduce their exposure — quickly runs into problems, as the Greek case has shown. Furthermore, the bond insurance scheme has a disciplinary effect on debtors as they will try to enhance their credit quality and avoid the payment of premiums. The ESM in turn does not have to raise funds in capital markets unless a default actually occurs.

A critical issue would be the setting of the premiums. Set them too high and the insurance will not be used. Set too low, and it degenerates into a disguised eurobond, a bond whose liability is jointly shares by eurozone countries. Instead, fees should be aligned to the rating of a country and structural factors like fiscal deficits or debt.

A simple formula could apply: the AAA refinancing costs of the ESM, plus a risk premium that reflects both the rating of the country and any progress it has made on its public finances. Setting the insurance fee in this way would incorporate an element of solidarity between countries, as fees would not be determined by actual market prices such as credit default swaps which can be sky high in a crisis situation. The pricing would have a positive incentive effect on the lenders: when a country improves its rating or structural factors, insurance fees will decline.

In case of a sovereign insolvency, the ESM would have to settle the insurance claim in cash or short-term ESM notes to the bondholder. The loss would depend on the amount of technical reserves that have been accumulated through insurance fees. If no sovereign insolvency occurs over the length of the contract, the accumulated fees could be used for building reserves or as a payout to the shareholders of the ESM.

Such insurance schemes are not a completely untested idea. They have been successfully employed during the banking crisis when lenders in the US and Europe took advantage of public guarantees. Credit enhancement — a form of sovereign bond insurance — was applied to the restructured Greek debt instruments after the insolvency of 2012. And it is basically also applied in national banking deposit insurance schemes where contribution rates are related to the rating of the contributing institution. There is no reason not to apply this concept to sovereign borrowers.