Economic Insight

European Sovereign Insurance Mechanism

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Executive Summary

- The eurozone remains vulnerable to another bond-market breakdown. It needs new and stronger safeguards – if it wants to avoid again to (mis-)use monetary policy as the only effective defense.

- Many ideas are on the table, ranging from an extended ESM over a common eurozone budget to new classes of government bonds (red/blue bonds or sovereign bond-backed securities, so-called ESBies). But all these proposals have shortcomings: they may discourage private capital, have not enough "firepower", take too long to take effect or are fair-weather constructs which in times of crisis do not strengthen containment but foster contagion.

- Time to take a fresh look at the idea of an European bond insurer. An European Sovereign Insurance Mechanism (ESIM) would have many advantages: It encourages private sector participation; it ensures that private investors keep their skin in the game as bonds are only partially insured; it has disciplinary effects as debtors have to pay a premium and the volume of insured bonds is limited; it uses the public guarantees very effectively by avoiding to raise funds in the capital markets; and last but not least, it can be implemented relatively quickly as part of the existing institutional structure: it is simply an expansion of the ESM toolbox.

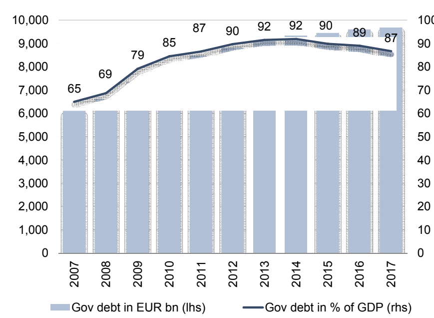
1. The eurozone is not out of the woods yet

The completion of Greece's financial-rescue program marks the closure of the eurozone crisis. However, this does not mean that the eurozone is out of the woods. Far from it. Admittedly, the last years were not wasted; institutional reforms – notably the establishment of the ESM and the banking union – made the eurozone more resilient. But vulnerabilities remain. Sovereign debt is still too high in too many places; banks are laden with bad loans – and national sovereign debt; cross-border capital flights continue, as shown by the rising Target-II balances; and economic imbalances between member states remain stubbornly high. In short: despite all the efforts, the eurozone still looks ill prepared if the next crisis breaks out (see following charts).

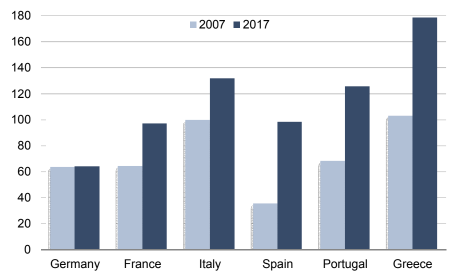
In fact, what really stands between the eurozone and the next crisis is the ECB, the European central bank, with its unconventional monetary policies: practically unlimited access to liquidity, negative interest rates, and several programs of bond purchases (QE). But the days of unconventional measures are numbered – and with monetary policy normalization the era of suppressed volatility and imposed calm on capital markets will end, too. In that respect, the recent episode in the Italian bond market – where spreads have surged after the announcement of a larger budget deficit by the new populist Government – or the repercussions from tremors in Turkey were just a foretaste. Without the ECB's safety net, financial stress could easily trigger more severe bond market dislocations in the eurozone and set the old doom-loop between banks and sovereigns in motion, with dire consequences for the real economy.

DEBT LEVELS REMAIN ELEVATED

Government debt, eurozone, in EUR bn and % of GDP



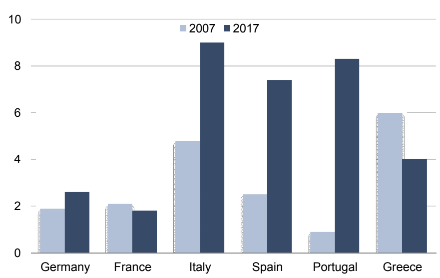
Government debt in % of GDP



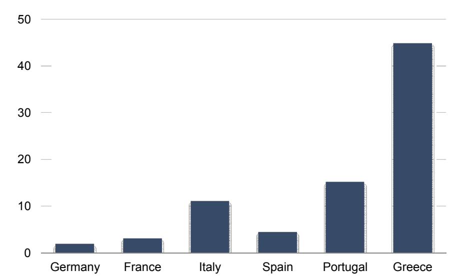
Source: Eurostat.

BANKS' BALANCE SHEETS REMAIN FRAGILE

Domestic government bond holdings in % or total assets



Non-performing loans in % or total assets, 2017



Source: ECB.

2. New proposed safeguards to bolster the currency union fall short of what is needed

Hence, the lively discussion about how to build up new defenses against the next shock. Proposals include a strengthened ESM; the completion of the banking union with a common deposit insurance scheme; an embryonic common budget for the Eurozone; or the creation of new classes of government bonds: red/blue bonds, accountability bonds or European safe bonds, so-called ESBies.

All these proposals have their merits but fall short of what is needed to avert the next crisis. Take the ESM. It has basically two shortcomings: Firstly, by providing direct lending, it discourages private sector lending as it creates the perception of private sector being subordinated, with negative consequences for any future debt relief for the private sector (see Greek PSI). But the ESM (and EFSF) disbursed more than EUR 200bn to Greece alone – is a rescue of, say, much bigger Italy without private capital thinkable? Secondly, by providing loans with strings attached (conditionality), it hinges upon the willingness of the government to accept and implement thorough reform and austerity measures. Given the populistic backlash in many euro member countries, a successful replay of past rescue programs seems highly unlikely this time around.

A common deposit insurance scheme would help to bolster confidence in the weak parts of the euro banking system. However, its implementation is still far off. First, banks have to get rid of their legacy problems, namely their pile of bad loans. Otherwise, a hasty implementation could yield the opposite of what is intended: acting as a vehicle of contagion, infecting the still healthy part of the euro banking system with the bad-loan-virus. The upshot: It is right to prepare the ground for a common deposit insurance scheme – but the next crisis might strike well before it is fully in place.

The same can be said about a common eurozone budget. It could help to reduce imbalance between member countries, boosting productivity and competitiveness in the laggard regions – if large enough and wisely invested. Easier said than done. But even if all the capital is spent for the right projects, the effects will be seen in years or decades. A common eurozone budget is something for the long haul, not something that can strengthen safeguards immediately.

New classes of government bonds do not have these shortcomings; they can be introduced at rather short notice. But the basic idea – splitting government bonds into senior and junior bonds – suffers from other shortcomings. The blue/red bond concept, for example, would not only imply new elements of collective liability for (blue) government bonds but could also render large stocks of outstanding (red) bonds subordinate, with dire consequences for overall financing costs. Accountability bonds fare better in this regard as they do not apply to debt stocks but only flows i.e. the financing of the current deficit above a certain threshold. But for countries in trouble, finding investors for these instruments might be extremely difficult. With no market access for new financing needs, it is rather implausible that other government bonds will not be infected. On the contrary: sky-high interest rates on any type of junior bonds could easily lead to a destabilization of the entire government bond market; in crisis, the result might not be containment but contagion.

At first glance, ESBies look better. It is an intriguing idea that tries to square the circle: building safe Eurobonds but without joint liability. The trick: creating a diversified portfolio of eurozone sovereign bonds which is then split into two tranches, the senior tranche, the so called ESBies, and the junior tranche, bearing the first losses. The ESM could play the role of issuer of these sovereign bond-backed securities. Although the idea looks very smart on paper, doubts remain whether it will function according to plan in reality. In good times, ESBies might simply act as a debt-accelerator as they ease access to financing for all members, regardless their creditworthiness; but in bad times, they could act as a crisis-accelerator: As usually in a crisis, spreads widen in all weaker countries and the senior tranche would not be immune – because there is no risk sharing; as a consequence, even the stronger countries would have to shoulder higher borrowing costs as most of their debt is issued in the form of ESBies. In the end, this instrument does not give incentives to reduce the overall volume of sovereign bond risk in the market; it just allocates the risk differently. Therefore, it will hardly improve the capability of the Eurozone to withstand a crisis.

3. A better alternative: The European Sovereign Insurance Mechanism

The concept of a sovereign insurance avoids most of the problems mentioned above. It actively encourages private sector lending; it avoids the heavy political burden of austerity programs; it can be implemented immediately; and it effectively reduces contagion, between sovereign debtors as well as between sovereigns and banks. Curtain up for the European Sovereign Insurance Mechanism (ESIM).

The idea is simple: Allowing the ESM to function as a bond insurer[1]. It would partly guarantee eligible sovereign bonds i.e. insure them against potential haircuts. Issuers wishing to make use of this guarantee would have to pay a fee. The insurance can be structured in many ways. Let us start with a simple example. Suppose a country with a BBB rating buys a 20% (first loss) insurance for newly issued bonds. This tranche of the bond would have an AAA rating as it mirrors the risk of the ESM. This would markedly increase the quality of the bond in the eyes of investors, especially as they will expect part of the uninsured 80% of the bond to be paid back in the case of a default (typically this can be assumed to be around 40-50%). Therefore, the interest rate on this bond issuance would significantly fall. Under plausible assumptions, Italy, for example, would not be paying 3.5% for 10 year sovereign bonds but might be able to reduce the charge to 1.5%.

[1] The ESM term sheet provides not only for the tools that were explicitly specified therein, but also for the option of expanding this toolbox. By awarding insurance coverage the original objective of the ESM does not change: providing financial assistance to euro area member states that are experiencing severe financing problems subject to strict requirements in order to safeguard the financial stability of the euro area as a whole.

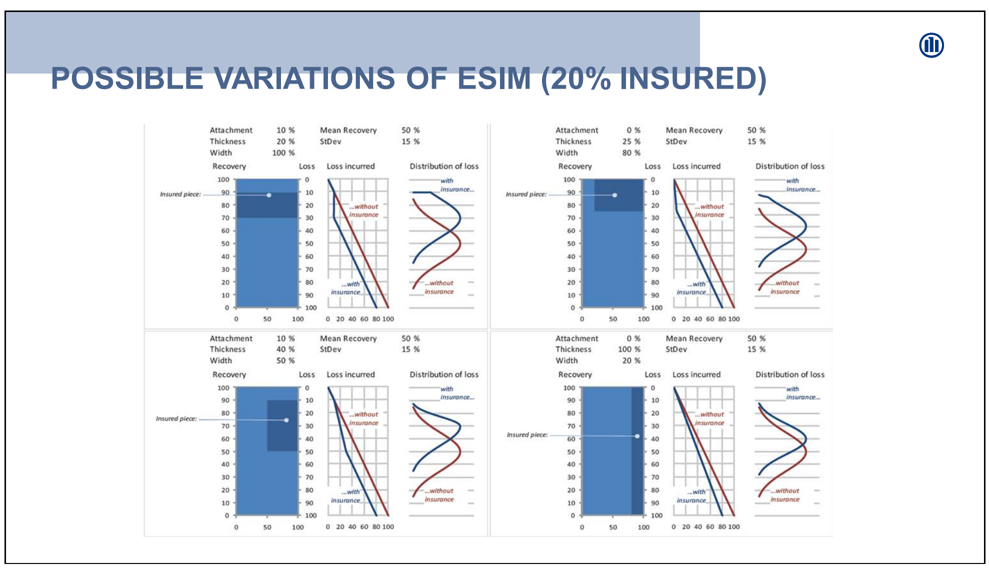
Of course, the sovereign insurance can be structured in many different ways, depending on three parameters:

- Attachment point: Bond holders are compensated for losses above a certain level, say 10%: the investor covers the first 10 Euro loss

- Thickness: the maximum amount of loss insured by the ESIM, say 20%: ESIM bears the next 20 Euro (after the investor has covered the first loss of 10 Euro) and any further losses are again covered by the investor

- Width: with a width of 100%, the next 20 Euro are fully covered by the ESIM. However, a more complex ESIM mechanism would require private investors to bear a certain portion of the potential losses (so called sidecar insurance): the ESIM insures the next 40 Euro, but only 50% of the losses (=20 Euro). The investor bears the other 50% and all remaining losses (including the first loss of 10 Euro).

The following graph shows different variations of the insurance, but all with the ESIM covering 20% of the loss. Although the insured amount remains the same, these different structures have an impact on the extent to which the insurance lowers interest rates. Generally speaking, the higher the attachment point and the smaller the width (sidecar insurance) becomes, the less the reduction in interest rates becomes.



4. Contours of the European Sovereign Insurance System

The ESIM's capital resources are in effect provided by the ESM. As part of the ESM, the ESIM has access to the ESM funds subject to the same conditions that apply to the other instruments. The ESIM employs the capital of the rescue facilities in a very effective manner:

- the ESIM uses 1 Euro to generate multiple Euro of funding for the crisis ridden state (in the case of a 20%-insurance the respective country can raise five Euros)[2]
- the capital that is needed does not have to be raised in capital markets but the already fully existing guarantees can theoretically be used directly
- if guarantees are used as opposed to loans, the ESM does not have to pay interest on the amount that is provided to the crisis states

The ESIM premiums (or guarantee fee) should be based on a long-term credit rating of the debtors, as opposed to monthly or quarterly economic data. As is standard practice for country rating processes, for example, this rating can be measured by a number of indicators that take into account not only deficit and sovereign debt developments, but potentially also imbalances in the development of a country's economy, like foreign account deficits or excessive wage developments in relation to productivity. When a country improves on these indicators, insurance fees will decline. This is a positive incentive for economic policy reforms.

Resulting premiums for the bond insurance has to fulfill two basic conditions: They need to be sufficiently low so that the all-in cost (bond coupon plus insurance) results in a sustainable cost of interest. And, as said, premiums should be dependent on reform progress, reflecting debtor nations' structural reform programs and consolidation paths to achieve sustainable finances. Most importantly, the process must be transparent and consistent to ward off any political interference. The final decision on the amount of the premium will then be made by the ESM Board of Governors.

Furthermore, the volume of bonds that could be insured with the ESIM will be set from day one. This means that more extensive borrowing would not enjoy insurance cover and would be based on increased market interest rates.

The structure of the ESIM also becomes clear if we look at what happens in an insured event. After all, the ESM itself has an indirect say in the solvency of the country in question when it decides whether to make additional liquidity assistance available or not. To a certain degree, this makes the ESM an insurance provider that can make its own decision on whether an insured event occurs or not. The very thing that would impede the trust placed in an insurer and its service promise in any other scenario actually has the opposite effect in this case. After all, one can hardly imagine that the right hand (the ESIM) will continue to provide security, heaping an increasingly weighty burden of

[2] In concrete numbers: The subscribed capital of the ESM (EUR 700bn) could be used to insure EUR 3,500bn of government debt. In contrast, the maximum lending capacity of the ESM stands at EUR 500bn. Italian outstanding government debt is close to EUR 2,300bn.

potential losses on itself, while the left hand (ESM) has long been busy with the preparations for debt restructuring. The ESIM really highlights the very thing that is often forgotten: even if the formal insolvency declaration has to come from the individual member state, as a way of expressing its national sovereignty, it is a political decision which, given the special circumstances of monetary union, is not made in isolation by an individual state, but rather is a joint decision made by all eurozone countries. The ESIM, and the burden that it has to carry in the event of default of an insured country, ensures that this political power is exercised responsibly. The ESIM lends additional credibility to the promise that debt restructuring will only be considered as a last resort.

If, however, this step, i.e. sovereign insolvency, does prove inevitable in the end, the ESIM has to settle the "insurance claim": the ESM will pay the insured amount in cash (or short-dated ESM Notes) and would receive the same notional amount of sovereign debt. The realized loss would be computed once a restructuring has been completed and the debtor sovereign is once again current.[3]

Given the structure of the ESIM as well as the above described process for claims settling, it is ensured that the insurance mechanism does not distort the incentives of the parties in a debt restructuring:

- without an attachment point greater than zero, creditors and debtors would have an interest to initiate a debt restructuring – since only the ESM would take a loss

- without the exchange of bonds for the insurance payout, the ESM would have no seat at the restructuring negotiating table – and bondholders no incentive to negotiate for any less than the maximum insured loss

5. Advantages of the ESIM

Private sector participation

Even in times of potentially difficult market access for a country, the insurance scheme makes sure that private investors stay involved in the financing of the country in question; for the "donor countries", this means that the need to continually come up with new rescue packages using public funds becomes superfluous.

Addressing the heart of the problem

The insurance solution is designed to lower the primary market interest rates, i.e. the marginal cost of borrowing – the heart of the problem. High secondary market yields are primarily a symptom of the problem (although they may exacerbate adverse feedback loops, e.g. via bank losses).

[3] An ISDA-style auction process could be pre-defined as a mechanism to calculate the loss.

Disciplinary effects

The disciplinary effects of the ESIM come in three different ways:

- Debtor nations have to pay an insurance premium that can be, for example, linked to whether criteria under the Stability and Growth Pact are met

- Second, a debtor nation only has a limited volume of insured bonds (per year or as a whole) available.

- As only part of the issue is guaranteed, the market still has a disciplinary effect on the country as the interest rates is still driven by the country risk, but in a smoothed way.

Effective use of capital

Public funds are used in an effective manner and expanding the “firepower” of the ESM in times of market turmoil. Also, when employing insurance as opposed to giving loans, the ESM does not have to raise funds in the capital markets and consequently does not have to pay interest.

Fast and simple implementation

The ESIM does not require the reorganization of European institutions, but can be incorporated into the existing institutional structure: The ESIM merely expands the ESM toolbox.

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