

A Three-Pillar Firepower to Solve the European Sovereign Crisis: A last chance!

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EU policy-makers, led by Germany, have a last chance to work together with the private sector to produce a comprehensive, multi-pillar framework to stop the pernicious spread of economic contagion from the sovereign debt crisis in Europe with its detrimental effects on the real economy and the society. The sovereign debt crisis and the turmoil in the banking sector have become intimately intertwined. Partial cures will not be strong enough to tackle the root cause of the disease, which has macro and micro origins resulting from the close relationship that has developed over decades between sovereigns and banks and been reinforced by the erroneous zero-risk weight treatment of the EEA countries under the Basel regulatory regime. Recent calls to increase core Tier-1 capital ratios (up to 9%) on all European banks without reconsidering the ratio's design profoundly miss the point. The experience of Dexia, which had a core Tier-1 ratio of approximately 12.1% in 2010, seemingly superior to the 9%, reveals the limits of these capital indicators to assess a bank's soundness.¹ Therefore, creating unnecessary noise in the market may derail policy-makers' efforts to solve the European sovereign debt crisis.

Our proposal is to tackle the sovereign debt and banking crises with a comprehensive multi-pillar mechanism that involves cash and synthetic solutions aimed at enhancing the European Financial Stability Facility (EFSF), but without entailing any structural transformation. In this framework, the public and the private sectors would collaborate to design the necessary tools (a blend of cash and guarantees) that would be capable of convincing the market. Central to this framework are the credibility of the public-private guarantee of potential future losses and the effectiveness of the instruments to be designed by the mechanism. This mechanism must be agreed at the highest political levels and implemented promptly to halt the downward spiral that can lead to a protracted recession in the EU – a scenario that is highly plausible today, if no credible political action is taken.

¹ See Willem Pieter de Groen, "A closer look at Dexia: The case of the misleading capital ratios", CEPS Commentary, 19 October 2011.

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The European sovereign debt crisis has immediate consequences for the sovereign bond market, as weak EU periphery countries may not be able to face redemptions on investors' claims, resulting in potential defaults with disastrous contagion effects to the core EU countries. The credit derivative swap (CDS) spreads, which signal the cost of debt insurance, have widened significantly, leading to a drying-up of liquidity in the most distressed countries. For instance, the cost of insurance of Greek debt has soared to unprecedented levels (up to 52% at the time of writing), which equally threatens other EU countries and EU banks with exposures to weak countries such as Portugal, Ireland, Spain and Italy. The European banking system, which has accumulated sovereign debt exposures in these countries and benefited from preferential regulatory treatment, now faces the prospect of either recognising these important losses on their books or putting in place mechanisms to recognise the losses progressively. In either case, EU banks will have to respond to the threat of depleting already-weak capital reserves. According to data published by the European Banking Authority in 2010, the EU sovereign debt exposure is estimated to total approximately €3 trillion, of which the PIIGS (Portugal, Ireland, Italy, Greece and Spain) account for 25.6% (approximately €760 billion). A deterioration of the sovereign debt crisis in Europe's periphery could further destabilise the bond and the CDS market and continue to weaken an already-vulnerable and poorly capitalised European banking system, while condemning Europe's periphery to a bleak future and ultimately spreading the distress to EU core countries.

In our view, the EU has already reached an advanced stage in this vicious loop and if it fails to take the appropriate measures, it could descend into a long-lasting recession. A number of market actors and academics have proposed innovative alternatives. Each has its advantages and disadvantages, but none provides a comprehensive answer to stop the spread of the disease.

Several market proposals have called for an increase in the firepower of the European Financial Stability Facility, which as it is designed today, does not offer a convincing answer to end the negative spiral in the markets because of its limited capacity. The proposals have called for either transforming the EFSF into a bank with unlimited access to ECB funding or providing it with new powers to purchase partially defaulted bonds, issue safer bonds or use guarantees to insure investors against some losses.

Transforming the EFSF into a special credit institution with potentially unlimited access to ECB funding in case of emergency has a number of advantages that have been well argued by Gros & Mayer.² However, some observers find that the involvement of the ECB as the lender of last resort is inappropriate and may subsequently undermine its independence and increase moral hazard as governments would relax their efforts at cutting deficits and debts.

The establishment of a new European Debt Agency (EDA) has also been proposed by a number of economists³ to buy sovereign bonds of the EU member states and reissue safe bonds. Indeed, the agency would hold the distressed bonds of the EU countries as assets in the balance sheet and use them as collateral to issue two types of securities using the 'tranching'⁴ and credit enhancement methodology: i) a senior claim on the payments from the sovereign bonds held in the portfolio and ii) a junior claim on these payments that would be first in line to absorb whatever loss is realised in the pool of sovereign bonds. In other words, in the event of default or partial default by a member state, the first loss would be absorbed by the holders of these junior tranches and not by the EDA. Essential to the scheme is the upfront agreement

² Daniel Gros & Thomas Mayer, "Refinancing the EFSF through the ECB", CEPS Commentary, August 2011.

³ The Euro-nomics Group, "European safe bonds", September 2011.

⁴ This is a technology that allows the taking of exposures at different levels of the capital structure of the portfolio.

on the realisation of losses for the bondholders and the pricing of the senior and junior tranches. Undoubtedly, this mechanism would create a natural buyer of the distressed sovereign bonds in circulation in the markets, would transform the supply using the tranching and credit enhancement methods and ultimately would increase the supply of European safe bonds which would fulfil the increasing demand by investors for risk-free assets. Such a mechanism would progressively stabilise the bond market functioning but may not be implemented as quickly as required in order to solve the pressing problems of the markets.

An alternative proposal by a leading insurance company⁵ sought to introduce an insurance mechanism to the EFSF. In brief, the EFSF successor would function as a bond insurer. It would partly guarantee the eligible sovereign bonds against potential haircuts for a fee. Such a mechanism would allow private-sector involvement in the rescue plan and could be implemented relatively quickly. This insurance plan is seen to create a two-tier bond market with lower yields on guaranteed debt than those on outstanding debt. However, it may run the risk of undermining the ability of the guarantor to raise money in the markets, which would put further pressures on lending costs.

An additional proposal⁶ would boost the supply of CDS in the market while potentially exercising a downward pressure on the spreads through a CDS transformer, which could benefit from an EFSF guarantee for a fee.

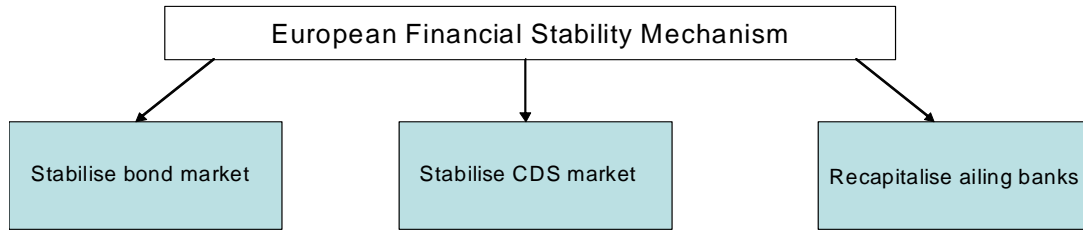
Taken separately, each of these proposals responds to an individual challenge but do not offer a comprehensive answer to respond to the severity of the EU sovereign debt crisis. Our proposal is to integrate these solutions in a comprehensive fashion and implement them using the already established EFSF, but without requiring any structural transformation. Increased capacity and prompt implementation are essential conditions to ensure the credibility and the effectiveness of the mechanism.

In a nutshell (see graph on next page), to stabilise the bond markets, the new comprehensive mechanism would be a public-private solution that would combine cash and synthetic instruments. It would purchase distressed sovereign bonds at an agreed haircut that convinces the markets. Using the tranching technology, the mechanism would rely on credit-enhancement instruments with a guarantee of the EFSF, the core EU member states and highly rated insurance companies to re-issue new risk-free/safer notes and possibly other types of less senior notes at a higher yield. The EFSF can also buy high-quality bonds not necessarily from the EU to diversify its portfolio and lower the correlation. To stabilise the CDS market, the enhanced mechanism would either provide guarantees to a specialised arm that writes protection on ailing countries and distressed banks or would issue these CDS while building the necessary reserves over time. The impact of safer note issuance in combination with the increase of supply of CDS would enhance the chance of reducing the cost of insuring, of funding and ultimately of dealing with default by ailing countries and banks. The EU banks will have incentives to accept an upfront haircut on the distressed sovereign bonds' exposure (or part of it), while having the possibility to swap the rest of the distressed exposure with safer notes or simply to buy a protection from the mechanism or the specialised CDS arm. These new 'safer' issuances can be used as collateral to obtain funding from the central banks. If it is necessary to recapitalise distressed banks (those that have weak capital ratios and suffered upfront large haircuts on their sovereign exposures), the mechanism could potentially guarantee subordinated debt instruments of banks that can be eligible as capital. Obviously, the latter should be seen as a temporary exceptional measure that needs to be revisited when market conditions are normalised.

⁵ Allianz, European Sovereign insurance mechanism (ESIM), October 2011.

⁶ <http://www.cooperatief.be/>

A three-pillar comprehensive rescue mechanism



European Financial Stability Mechanism	
A	L
Sovereign PIIGS with a haircut	Subordinated debt issuance
	Safe Notes Junior Notes
Guarantees from EFSF Core MS & Insurance Co....	Guarantee to the European CDS Facility

Source: Author.