Consultation response

European Commission Inception Impact Assessment – *Enabling regulatory framework for the development of sovereign bond-backed securities*

20 February 2018

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the regulatory framework for the development of sovereign bond-backed securities ("SBBS"). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

Introduction

AFME's Primary Dealers' Division addresses specific primary and secondary market issues arising across Euro government securities markets and recommends best practices in those markets on behalf of the Eurozone top 25 government bond primary dealers. AFME's Prudential Regulation division also provided input.

Our response is structured in two parts, one providing general comments on market considerations on SBBS, and the second one looking at regulatory aspects linked to the proposed regulatory framework.

AFME supports proposals which further integrate European capital markets, advance the completion of the Banking Union and deepen the Economic and Monetary Union. We note that this is one of the reasons for current reflection regarding the creation of a European "safe asset". At the same time, AFME believes that a number of essential criteria to successfully develop a market for SBBS have not yet been met. More importantly, we have some concerns on the unintended consequences such instruments as designed could have on the functioning and liquidity of the European government bond market.

In this context, and taking into account the crucial role sovereign exposures play in banks' risk management and profitability, as well as for sovereign debt markets, we would respectfully request the Commission to undertake further reflections with stakeholders on this topic.

1. ***Market demand and feasibility considerations***

   a. Demand

The success of SBBS will depend, among other factors, on the market demand for such products. Aside from regulatory treatment which SBBS may receive, investors will also consider risk, return and liquidity in evaluating the case for purchasing senior or junior tranches of SBBS. European government bonds are already, for the most part, highly liquid securities and this is one of the reasons why market participants invest in them. Asset-backed securities have traditionally been less liquid than government bonds.

Therefore it is unclear to us whether a sufficiently large pool of investors would be attracted to SBBS as they can already build portfolios replicating what would be the underlying portfolios of SBBS, with the ability to shift risk more easily than if they were holding tranches of SBBS. This would impair the liquidity of SBBS senior tranches which are targeted at those who currently invest in liquid sovereign bonds.

b. Structure

In terms of its structure, the proposed framework assumes a construction where the junior or mezzanine tranches represent 30% of the total portfolio and the senior tranches 70%. The key to a good structured finance product is diversification via a low correlation of assets. Indeed, for credit rating agencies, the ratings will depend on the correlation assumption among the sovereigns in the different tranches. However, the Greek, Cypriot and Italian crises showed that there can be contagion effects when one country defaults. The SBBS would be built on 19 sovereigns that in practice are highly correlated. For instance, the risk premium in a country with a lower rating is highly likely to spill-over as we saw several times during the crisis. This means that trust in SBBS will be lowest when they are most needed in times of crisis, making it a "fair weather" instrument rather than a safe asset.

It is therefore optimistic to assume senior tranches will be automatically AAA. In fact, under the weak-link approach proposed by one rating agency to rate a possible SBBS, and a hypothetical split of 70%/30% between the senior and junior tranches, the senior tranche would be rated BBB-.[1] As a result, this study has shown that SBBS could actually lead to a decrease in the supply of AAA assets or lead to AAA-rated sovereigns being repackaged into lower-rated assets, which cannot be the intention. In order for SBBS to succeed, investors and rating agencies need to be assured of the low risk status of the senior tranche: a convincing case for this has yet to be made.

Further, SBBS will inevitably be compared with the unfortunate historical precedent from the financial crisis of collateral debt obligations or "CDOs". While it is true that the underlying assets in CDOs (US sub-prime mortgages) were very different from government debt, they failed not just because of poor credit performance but also because the underlying assumption of low correlation was incorrect. In reality, in conditions of stress, the correlation turned out to be very high, with the highly damaging and systemic results which are well documented. Because of this relatively recent experience, it will be very difficult to convince investors and rating agencies today to make similar correlation assumptions in the context of SBBS, however different the underlying assets may be.

c. Liquidity and market impact

One of the motivations for the creation of a European safe asset is to weaken the link between sovereigns and banks. This link expresses the concern that a sovereign's creditworthiness can come under pressure if it needs to bail out failing banks to secure financial stability. In turn, banks' finances could suffer if the sovereign government in their country of domicile were to default on its bonds, since some banking systems in the eurozone hold a substantial amount of domestic sovereign bonds. These two effects can reinforce each other, creating a vicious circle. Post-crisis reforms have helped address this problem. In the EU, the introduction of the Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism Regulation (SRMR), the continued development of the Banking Union, and the current implementation of Total Loss Absorbing Capacity (TLAC) requirements into the European resolution framework, have weakened the link between a sovereign and its banking sector. As resolution authorities have the power (among others) to bail-in a bank's creditors, the transmission of risk from a failed bank to the taxpayer is not as great as it was in the run up to, during and immediately after the global financial crisis.

From a systemic risk perspective, the ECB's Outright Monetary Transactions (OMT) and commitment to pari-passu status on debt restructuring were important stabilizing features in the crisis. Making part of

[1] How S&P Global Ratings Would Assess European "Safe" Bonds (ESBies), Moritz Kraemer, 25 April 2017

the debt "junior" could undermine those mechanisms. For some eurozone countries, this could potentially have an impact on funding costs and spreads.

More specifically, because under the current proposal the senior tranche would be based on GDP weights or ECB capital, the debt of core countries would end up in the collateral portfolio – making them illiquid, while, for other countries, a large residual debt would be left outside the pool.

For the latter, the proposed instrument risks fragmenting the market between the debt that will end up in the collateral portfolio of the SBBS, and the remaining outstanding debt the liquidity of which may be diminished as well.

We also believe that the hypothetical size of €1.5 tn for the SBBS market, as envisaged by the ESRB, seems optimistic given the size of the actual government bond market (€7.6 tn as of Q3 2017[2]) as it would make up for around 20% of the outstanding Eurozone government bond market. Looking at the junior tranche and the estimated market size of €150bn, it is unclear whether there would be sufficient market capacity to absorb it. The report from the ESRB refers to institutional investors (insurers and pension funds in particular) as possible investors. This would require a distinct regulatory treatment as treatment as "regular mezzanine ABS" will not suffice.

2. *Regulatory considerations*

The regulatory treatment of SBBS is clearly a key consideration in the design of the framework as this can create strong incentives or disincentives for market participants to issue, purchase or trade SBBS. In our comments below, we identify a number of key regulatory considerations that we believe would affect the viability and attractiveness of the new framework.

It is noted in the inception impact assessment document that levelling the regulatory playing field between SBBS and their underlying bonds would require adapting the regulatory framework for securitisation to better reflect SBBS' defining and distinguishing features. The ESRB has, meanwhile, called for a more favourable regulatory treatment for SBBS than for other asset backed securities. This would involve a treatment no worse than that of government bonds for senior tranches of SBBS, while for the mezzanine and junior tranches, an adjusted treatment to reflect their comparatively higher risk profile.

AFME believes that any proposal should encompass the holistic treatment of the SBBSs and should cover not only the prudential treatment but also their eligibility criteria to be accepted as a collateral by the ECB, liquidity ratios, and the tax regime of these new financial instruments, otherwise an investor would therefore always prefer to buy the underlying portfolio instead of the SBBS. We note below some initial challenges and observations we identify in certain regulatory areas.

- Neither senior nor non-senior SBBS would qualify as liquid assets under the LCR. A change to the list of eligible assets could see senior tranches become eligible as Level 2b assets and subject to a 25% minimum haircut but this clearly differs from the Level 1 classification of all sovereign bonds.

- In terms of the NSFR, it is proposed that sovereign bonds should attract a 0% required stable funding factor whereas securitisations attract much higher charges. The NSFR adopts also the same definition of liquid assets as the LCR which has implications in that SBBS would not qualify as collateral.

- Regulatory capital requirements for securitisation products are significantly higher than those for sovereign bonds. In the Capital Requirements Regulation there is generally a floor for the risk weight of securitisation positions of 7% for banks using IRB approaches and 20% for banks

[2] AFME Government Bond Data Report, Q3 2017

using the standardised approach. This contrasts with many banks being able to hold government bonds at 0% under the standardised approach to credit risk.

- In relation to the Fundamental Review of the Trading Book ('FRTB'), SBBS bonds would need to be re-classified to avoid treating them as securitisations. Otherwise, banks would not be able to hold inventories for market making purposes as securitisations attract a punitive standardised methodology that results in disproportionate outcomes.

- Whether and how SBBS qualify as collateral under the Eurosystem collateral framework would have significant implications for the investor base for SBBS and market price.

It is particularly important that any adjustments to the regulatory framework are carefully considered not just with the aim of developing an SBBS market but also with the perspective of ensuring that the introduction of a potential new instrument does not lead to distortions and unintended consequences on the broader regulatory framework. The post-crisis framework across asset classes has been carefully calibrated at international level. We strongly believe that international coordination in the adoption of any potential change in the prudential treatment of sovereign risk is crucial to avoid fragmentation of financial markets and competitive disadvantage for European markets.

Conclusion

While AFME supports continuing discussion regarding the creation of a European "safe asset", we regret to say we have genuine and sincerely held doubts regarding the feasibility of the Commission's proposals as they currently stand. Our members have concerns on the potential unintended consequences on European government bond markets, particularly the knock-on effect that this proposal could have on market liquidity.

We therefore encourage the Commission to consider further consultations with stakeholders before deciding to progress this initiative further. A European initiative on SBBS would require significant planning and coordination among stakeholders involved in government bond markets, including official bodies, debt management offices, primary dealers and investors. The issues identified in this response would need to be addressed, particularly the need for regulatory clarity. Any new framework should establish the same prudential treatment agreed at international level in order to avoid potential inconsistencies between European regulation and international standards and to ensure a level playing field across jurisdictions.

AFME will remain engaged with our members as discussions continue and we look forward to maintaining a dialogue with EU and national authorities on the subject.

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