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An Alternative to Sovereign Bond-Backed Securities for the Euro Area

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A proposal put forward by the European Commission (EC) for the regulation of sovereign bond-backed securities (SBBSs) follows the release of a high-level taskforce report, sponsored by the European Systemic Risk Board, on the feasibility of an SBBS framework. SBBSs would be created through a securitization process similar to that of a collateralized debt obligation (CDO) structure by pooling national sovereign bonds and slicing the pool into senior, mezzanine, and junior securities, each with a range of maturities. The senior tranche is to be designated a "safe asset," with at least the same rating and return as German bonds.

This SBBS scheme is designed to address two problems afflicting the euro area's financial system (or, to the point, systems). First, the absence of a common yield curve means that the euro area does not truly have a single financial market. The SBBSs would serve as the common asset required to create such a yield curve. Second, the SBBS proposal is supposed to break the link between bank crises and sovereign debt crises in the eurozone (the so-called "doom loop") by shielding banks from sovereign crises and preventing banking crises from turning into sovereign debt crises.

It is doubtful the proposal would yield its intended results. First, hardly any financial operators in triple-A-rated countries would agree to swap their national debt with equally profitable but more uncertain synthetic assets, thus preventing the scheme from reaching the necessary scale. Second, given the limited number of systemically correlated assets involved and the participation of national assets according to the ECB's capital key, the pool would not be sufficiently diversified to permit using the usual CDO methodology, which means the multiplier effect necessary to drive the production of safe assets would not be generated. Further, a range of underestimated costs—along with the need to maintain sufficiently enticing profit margins for the private financial institutions originating and distributing them—would significantly complicate the plan to make the requisite amount of senior tranches of SBBSs equivalent, in terms of safety and yield, to the highest-rated national sovereign bonds. It is therefore doubtful that private operators could produce a sufficiently large and stable volume of safe assets with the initial maturities required to build a risk-free yield curve.

The proposed EC regulation—which aims at subjecting SBBSs to the same financial regulatory requirements as their underlying national sovereign bonds—does not appear to surmount the aforementioned difficulties. Attempts to add flexibility to address complications with the SBBS scheme undermine the ability of the scheme to establish a common yield curve for the euro area—one of the original plan's two central purposes. Worst of all, the scheme, though regarded by the EC as just a "market test," may in several ways undermine rather than bolster financial stability.

There are better options. My alternative would involve the European Central Bank (ECB) issuing debt certificates (DCs) along the maturity spectrum to create a common yield curve. Through corresponding operations, the ECB would absorb a share of each eurozone country's national debts (according to ECB capital keys). Alongside these financial operations, new fiscal rules incorporating more ambitious targets for sovereign debt ratios would be imposed—with more drastic consequences for noncompliance, but a more favorable influence on euro area economic growth (as compared to the futile, deflationary fiscal dynamics built into present arrangements). This alternative proposal not only better addresses the two problems targeted by the SBBS scheme, but also a third, critical flaw of the current euro system: that is, it fosters national sovereign debt sustainability.

More broadly, the DC proposal aims at the central defect of the eurozone setup: having a monetary policy operated as if serving a federal state while fiscal sovereignty remains at the national level. To be effective, a common monetary policy requires a single financial market, and that in turn requires all participants to operate with the same risk-free assets—for liquidity purposes and for pricing risks—and the same risk-free interest rates. Lacking the reference to a common public debt, the alternative introduced by this proposal is to have the ECB produce the required risk-free assets with maturities encompassing the whole yield curve. A mixture of benefits linked to the ECB's acquisitions of public debt, new reflationary (but debt-reducing) fiscal rules, and strong incentives to remain inside the scheme render the convergence to debt sustainability much easier than at present, and more compelling. Politically, it would signal that the union—through adjustments directed at increasing the coherence of its institutional setup, without requiring EU treaty changes—is undertaking a serious effort to mend social wounds, not leaving troubled countries to fend for themselves.

A more detailed discussion of the issues can be found at levyinstitute.org/publications/european-sovereign-bond-backed-securities-an-assessment-and-an-alternative-proposal.

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