CEPS COMMENTARY
Thinking ahead for Europe

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

**Rym Ayadi**

**21October 2011**

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.

Rym Ayadi is Senior Research Fellow at the Centre for European Policy Studies, where she heads the Financial Institutions and Prudential Policy research unit. She gratefully acknowledges useful discussions with Daniel Gros and Karel Lannoo, among others, as background to this Commentary. The final section on "Modalities, functioning and advantages of the EFSM" was added on 24 October 2011, as an elaboration of the basic proposal.

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 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 enhance 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 economists[3] 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

[2] Daniel Gros and 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.

is the upfront agreement 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 company[5] 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 proposal[6] 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.

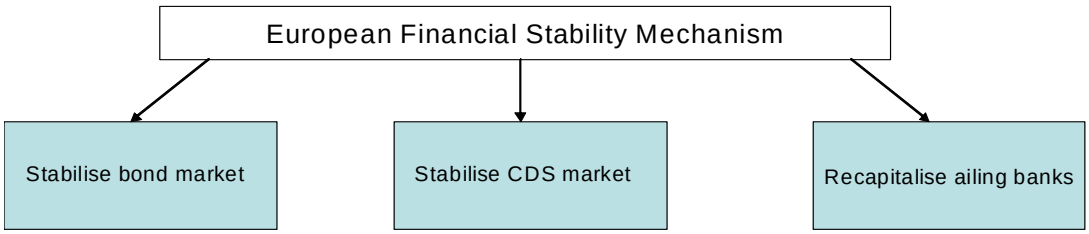
In a nutshell (see Graph 1), to stabilise the bond markets, the new comprehensive mechanism would be a public-private solution that would combine cash and synthetic instruments. It would purchase distressed sovereign bonds at an agreed haircut that convinces the markets. Using the tranching technology, 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 could 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.

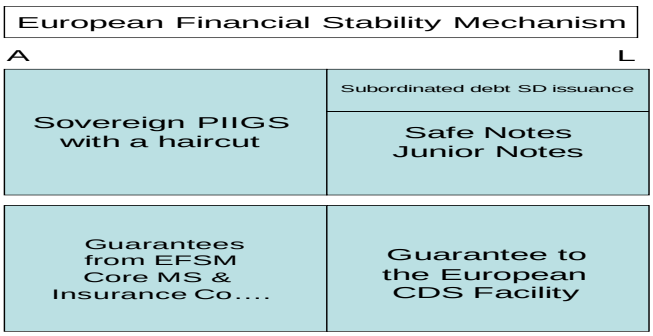
---

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

[6] http://www.cooperatief.be/

***Graph 1. A three-pillar comprehensive rescue mechanism***




*Source*: Author.

## Modalities, functioning and advantages of the EFSM

The EFSM will take the form of a public-private mechanism that will ultimately serve the public interest. As an enhanced version of the EFSF, there is no need for structural transformation. It should remain registered in Luxembourg, under the ownership by euro area member states. Its mandate is to safeguard financial stability in Europe by providing financial assistance to euro area member states and their banking industries and capital markets. The mechanism would aim to stabilise bond and CDS markets and if necessary to recapitalise euro area banks. The mechanism will not necessitate a structural transformation by means of banking license, but it would be closely monitored by the ECB.

The mission of the EFSM would include:

1. Buying distressed sovereign bonds from weak countries (with an applied haircut), keeping them as collateral and using tranching technology and credit enhancement to issue structured notes or other debt instruments on the capital markets;
2. Writing protection or guaranteeing the CDS arm to write protection on the junior tranches of the new issuance; and
3. Providing guarantees on subordinated debt of EU distressed banks.

As with the EFSF, the EFSM would remain backed by guarantee commitments from the euro area member states for a total of €780 billion and would have a financial capacity of €440 billion. Obviously any political decision to increase the capacity of the fund would welcome. In addition, the mechanism would be open to highly rated private insurance companies that wish to provide their guarantee with a cost. This will further increase the outreach of the mechanism.

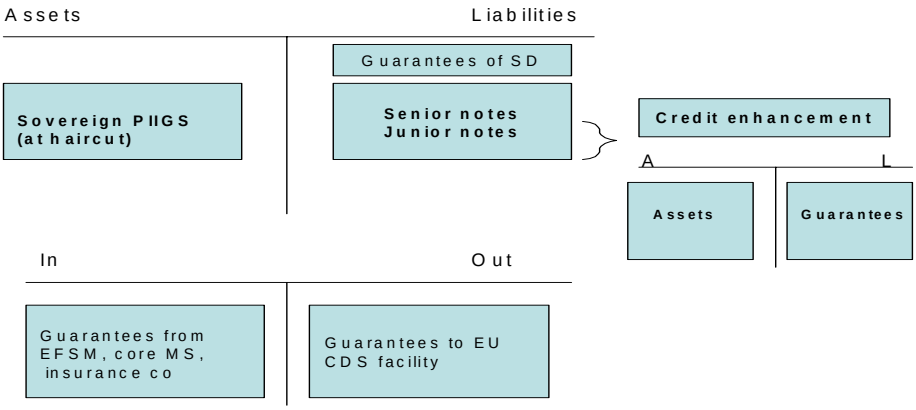
It goes without saying that the mechanism must maintain the highest possible credit rating.

This mechanism would be open to the eurozone banks that have EU sovereign exposures on which a haircut was applied. The higher the haircut, the lower would be the need for public guarantees to support the mechanism. However, it should be noted that the success of the

mechanism will also depend on the participation of the financial sector and therefore their agreement on the haircut applied. The new instruments of the mechanism would serve to absorb the distressed EU sovereign assets and transform them using public and private credit enhancements and guarantees into 'safer' assets and other types of junior assets that can be more attractive to the participating banks and international capital markets.

As shown in Graph 2, the safer notes would be structured in such a way as to grant the right to a senior claim to the payments from bonds held in the portfolio. The mechanism could also diversify its holdings to non-EU investment grade notes in order to lower correlation. The newly issued safer notes will pay the first loss despite potential default of the distressed bonds thanks to the guarantee by the EFSM and core member states. The second loss will be insured by the participating insurance companies in the mechanism. The insurance of such a second loss will not be without a fee. The junior notes would be sold to the willing investors in the capital markets. These notes will be considered as risky securities. Therefore, if the underlying, which is composed of the distressed bonds, fails to pay in partial or in total, then the loss would be directly absorbed by the holders of the notes. Investors willing to hedge these exposures would participate in the CDS arm of the EFSM.

*Graph 2. Balance sheet and off balance sheet of the mechanism*




*Source*: Author.

After applying the haircut, the participating banks would have an incentive to swap the rest of their exposures for newer notes issued by the mechanism. The senior notes, which are obviously 'safer', would be accepted by the ECB in its repos and discounting operations and might not be subject to capital requirements. The junior notes, which are riskier instruments, would not have any preferential treatment.

Ailing banks, which were exposed to the EU sovereigns and have low capital, will benefit from EFSM recapitalisation instruments. These could take the form of guarantees of subordinated debt that could qualify as capital.[7]

The mechanism would also provide other types of guarantees to a CDS facility arm that would write protection on weak countries and regional authorities and ailing banks.

Other financial institutions can also participate in the mechanism if they wish to accept the applicable haircut. The new notes issuance would also be open to international investors.

The EFSM is an attractive solution to safeguard financial stability in Europe. Indeed, progressively, the distressed assets in the PIIGS will be absorbed by the mechanism and transformed into two classes of assets. The safer asset will be held in the EU banks that were exposed to the PIIGS and the junior assets by the sophisticated investors able to hedge the underlying risks through the new CDS issuance, partly guaranteed by the mechanism.

[7] This treatment must be reconsidered once market conditions are normalised.

Weak countries would have incentives to continue efforts to cut debt and deficits, while remaining subject to the troika agreement. However, they could also issue new bonds to refinance their payments obligations and EU banks would still have the incentive to buy them and use the EFSM to recycle them in an instrument that ultimately will be reused by the ECB as collateral.

This mechanism will not be more costly to taxpayers in core member states as they are designed in a way to be attractive to international capital market participants, who would be willing to participate eventually in order to reduce the current widespread downward pressure in the market.

Our expectation is that over time, the bond and CDS markets would be stabilised and the EU banking industry would shore-up its capital and liquidity.