European Commission - Fact Sheet

Frequently asked questions: Enabling framework for sovereign bond-backed securities

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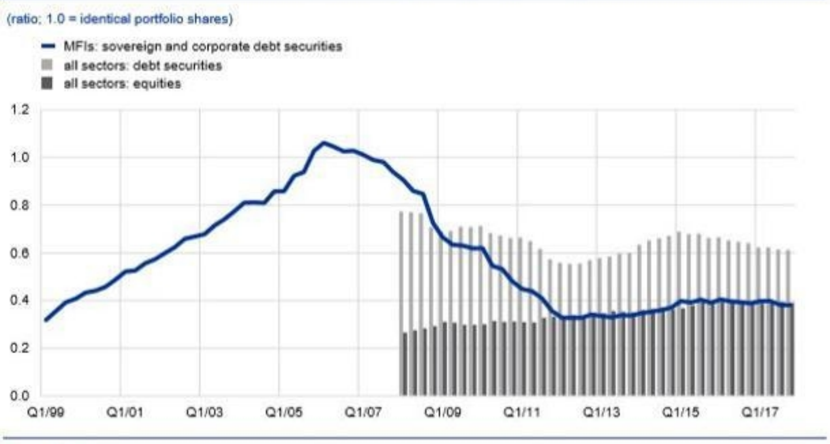
What are SBBS and why would they be a helpful addition to the financial landscape?

According to the criteria outlined in the Commission proposal, sovereign bond-backed securities (SBBS) would take the form of low-risk liquid assets backed by a pre-defined pool of euro-area central government bonds.

SBBS are a market-led solution to promote financial integration, reduce the 'home bias' in investors' portfolios and facilitate the diversification of their sovereign exposures. For banks, SBBS would contribute to further weakening the link between banks and their governments. And they would add another type of low-risk liquid asset in the financial system.

Indicators of intra euro area cross-border portfolio allocations



Source: ECB.
Notes: A rising ratio indicates that euro area investors are allocating an increasing portfolio share to euro area assets outside their domestic market relative to the portfolio share allocated to their domestic market. A higher ratio therefore indicates a higher degree of cross-border euro area financial market integration. MFIs exclude the Eurosystem.
Latest observation: Q4 2017.

SBBS will be helpful in advancing the completion of the Banking Union and the Capital Markets Union, leading to a deeper Economic and Monetary Union (EMU). They will reduce risks through enhanced risk diversification by spreading risks more widely across investors and across borders. SBBS will also contribute to expanding the supply of low-risk and liquid assets and create more integrated and diversified financial markets in sovereign debt. This will also be beneficial for the development of the Capital Markets Union. SBBS would, by design, not involve mutualisation of risks and losses among euro area Member States. Only private investors would share risk and possible losses.

A high-level task force created under the aegis of the European Systemic Risk Board (ESRB) to assess the feasibility, merits and risks of sovereign bond-backed securities issued a comprehensive report in January 2018.Based on this work and its own analysis, the Commission developed an enabling framework for the development of a market for SBBS to support further portfolio diversification in the banking sector.

How would SBBS work?

SBBS would be a new type of asset created by the private sector based on a pre-defined pool of sovereign bonds of the Euro area Member States. In practice, a private sector entity, created solely to issue and manage SBBS, would buy euro area sovereign bonds on the market and bundle them into higher or lower risk securities. Investors could buy higher or lower risk packages, according to their risk appetite.

This entails a two-steps process:

- The creation of a diversified portfolio of euro area, euro-denominated sovereign bonds with characteristics defined by the proposed regulation. The underlying pool of an SBBS would only include sovereign bonds of Member States whose currency is the euro.

- The sale of securities to investors, with the buyers of each package of securities (or 'tranche') enjoying a different ranking, or 'seniority', in the case of losses occurring on the underlying portfolio.

In other words, the highest-risk securities (known as 'junior') would be first in line to bear any losses on the underlying pool should they arise, but would in exchange pay investors a higher return. Senior securities would be low-risk, as they would bear losses only in the (very unlikely) case that the junior tranche has to be fully written off to absorb the losses.

Specifically, the proposed Regulation stipulates that:

- The underlying portfolio must include sovereign bonds of all euro area Member States, with relative weights in line with each Member State's contribution to the capital of the European Central Bank (the so-called ECB capital key). This is because the ECB capital key is a proxy of each Member State's economic stake in the euro area economic and financial system.
- The debt service (interest plus redemption) obtained from the underlying portfolio is assigned to the various SBBS claims according to their seniority. The size of the senior tranche is fixed at 70% of the overall SBBS issuance. This will ensure that it is as safe as the least risky euro area sovereign bonds. The remaining 30% can be divided in as many sub-senior (or subordinate) claims as the issuer finds best suited to the demand of its investors.

How would SBBS currently be treated from a regulatory perspective and what changes is the Commission proposing?

Under current rules, SBBS would be treated significantly less favourably than the euro-area sovereign bonds constituting SBBS' underlying portfolio, e.g. in terms of capital requirements, the eligibility for liquidity coverage and collateral, etc.

Today's legislative proposal aims to level the playing field by removing unjustified regulatory impediments to the development of SBBS by the private sector. As SBBS would present lower risks than traditional securitisation products because of the nature of their underlying assets (low-risk, liquid and well-known euro-area sovereign bonds) and as the portfolio composition is pre-determined, the Commission proposes to adjust the regulatory framework to facilitate the issuance of SBBS by better reflecting SBBS' defining and distinguishing features.

This would mean that SBBS would enjoy the same regulatory treatment as national euro-area sovereign bonds (in terms, for example, of capital requirements or eligibility for liquidity coverage and collateral).

In particular, the legislative proposal:

- Introduces a definition of SBBS, including a list of features required for any privately-produced securitisation of euro area national government bonds to qualify as SBBS;
- Ensures that the regulation treats investments in SBBS and in government bonds in a consistent manner.

What can be labelled as SBBS?

In order for a product to be labelled SBBS, the issuer has to follow an 'SBBS recipe'. The recipe is defined in the proposed Regulation: the pool underlying the SBBS tranches has to be composed according to predefined fixed weights that correspond to the ECB's capital key (taking into account all euro area Member States). SBBS have to be issued in euro.

This 'SBBS recipe' creates a standardised product, which in turn enhances the product's appeal (e.g., in terms of liquidity).However, in very specific cases, the recipe may require some changes to support the development of the market. These specific cases are defined in the proposed regulation:

- If a Member State is issuing too little debt, so that it becomes impossible (or prohibitively difficult) to gather the necessary amount of bonds as required by the proposal;
- In some cases it would be possible to adjust the size of the senior tranche to preserve its high rating (for example, following deterioration in the credit standing of one or more underlying sovereign bonds).

What is the difference between SBBS, Eurobonds and a so-called European Safe Asset?

SBBS are financial instruments created by the private sector, based on euro-area sovereign bonds. By design, SBBS would not involve any mutualisation of risks and losses among Member States.

SBBS are therefore different from Eurobonds, which do involve mutualisation of risks and losses among Member States.

SBBS are also different from the European safe asset as outlined in the EMU deepening Reflection Paper. The latter is meant as a new financial instrument for the common issuance of debt. The

Commission services are assessing the possible features and feasibility of a possible European safe asset.

Why are sovereign bonds from non-euro area Member States excluded?

Sovereign bonds from non-euro area Member States are excluded because they would involve additional risk linked to exchange rate. If a non-euro area Member States joins the euro area, their sovereign bonds would become eligible and would, in fact, have to be included in new issuances of SBBS.

How are non-euro area Member States affected?

Non-euro area Member States would not be directly affected, since SBBS would only comprise euro-area sovereign bonds. Nevertheless non-euro area Member States stand to benefit from SBBS *indirectly,* to the extent that SBBS foster a more integrated and hence stable and resilient euro area.

What impact is the proposal expected to have?

The levelling of the regulatory playing field would enable – but not guarantee – the development of a SBBS market. This should help achieve the goals mentioned above (i.e., greater diversification of banks' sovereign exposures; weakening of spill-overs from sovereigns to banks; creation of a new low-risk and liquid asset based on government bonds of all euro area Member States, etc.). This could support investment and growth. These effects could be expected to be larger for those Member States most exposed to risks from adverse sovereign-bank spill-overs at present.

What about existing sovereign bond market liquidity?

The SBBS market is expected to develop gradually, and even once the market is fully developed, SBBS are not expected to replace the largest part of the market for national sovereign debt. Rather they are expected to exist next to the national sovereign debt markets Since national bonds no longer trade separately once they are included in an SBBS portfolio, there may be adverse effects on the "float" (or amount that is routinely traded) of individual national bonds, but these are expected to be limited, due to the expected limited size of the SBBS market.

At the same time, SBBS may be liquidity-enhancing because they may attract new investors. This would be especially important for Member States that currently do not manage to appeal to global investors, for example because of limited debt issuance. To the extent that SBBS achieve their stability-enhancing goals, they would help reduce overall risk and thus national governments' funding costs.

Neither the proposed legislative initiative, nor the SBBS market are expected to have a direct impact on individual savers, households or SMEs, because they would unlikely be active in SBBS markets. These sectors would however benefit indirectly, including from enhanced market confidence, through the progressive developments of SBBS market.

What role has the ESRB played in this proposal?

In mid-2016 the European Systemic Risk Board (ESRB) set up an inter-institutional High-Level Task Force (HLTF) to assess SBBS's merits, risks and feasibility. The HLTF comprised representatives from many Member States' central banks and financial supervisors, as well as of the European institutions such as the European Central Bank and the European Commission and agencies such as the European Banking Authority and European Insurance and Occupational Pensions Authority, public debt management officers and academics. This proposal builds to a large extent on the work of the ESRB HLTF to which the Commission actively contributed.

What are the next steps?

The proposal will now be discussed by the European Parliament and the Council.

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