The euro-area safe asset problem: an hybrid solution

Garicano-Reichlin proposal in progress

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Where are we now in the euro area crisis?

- The economy is at best stagnating

  -- not out of the 2011 recession yet

  -- diverging from the US

  -- employment flat
- Debt not stabilized
- Financial fragmentation (and relatively high credit risk in the periphery) not over

➢ The crisis is not over!

Yet, low volatility … the market does not seem to price this risk … but the market has been wrong before! … an illusion of tranquility?

Risk-on/Risk-off: Between safety and paranoia

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- A worrying feature of the current state of the financial markets is their tendency to oscillate between periods of “risk off” and “risk on”
- The uncertain governance of the European monetary union accentuates this binary dynamic:
  - the market either believes in a full commitment of the central bank to bailout individual sovereigns, in which case it ignores credit risk, or
  - it doubts the commitment of all the monetary union, in which case there is a flight to safety generating excessive risk premia which incorporate redenomination risk

“Risk-on” in 208 and then 2011 has taken the form of home bias in banks balance sheets

- 2007/2009 first recession: liability side – inter-bank funding

- 2011 second recession: asset side – government bonds

…. LEADING TO THE SO-CALLED ‘’DIABOLIC LOOP’’ BETWEEN BANKS AND SOVEREIGN

Banks’ balance sheets: how unusual since 2008?

Liabilities: funding stress is from non-residents

(Colangelo et al, 2013)

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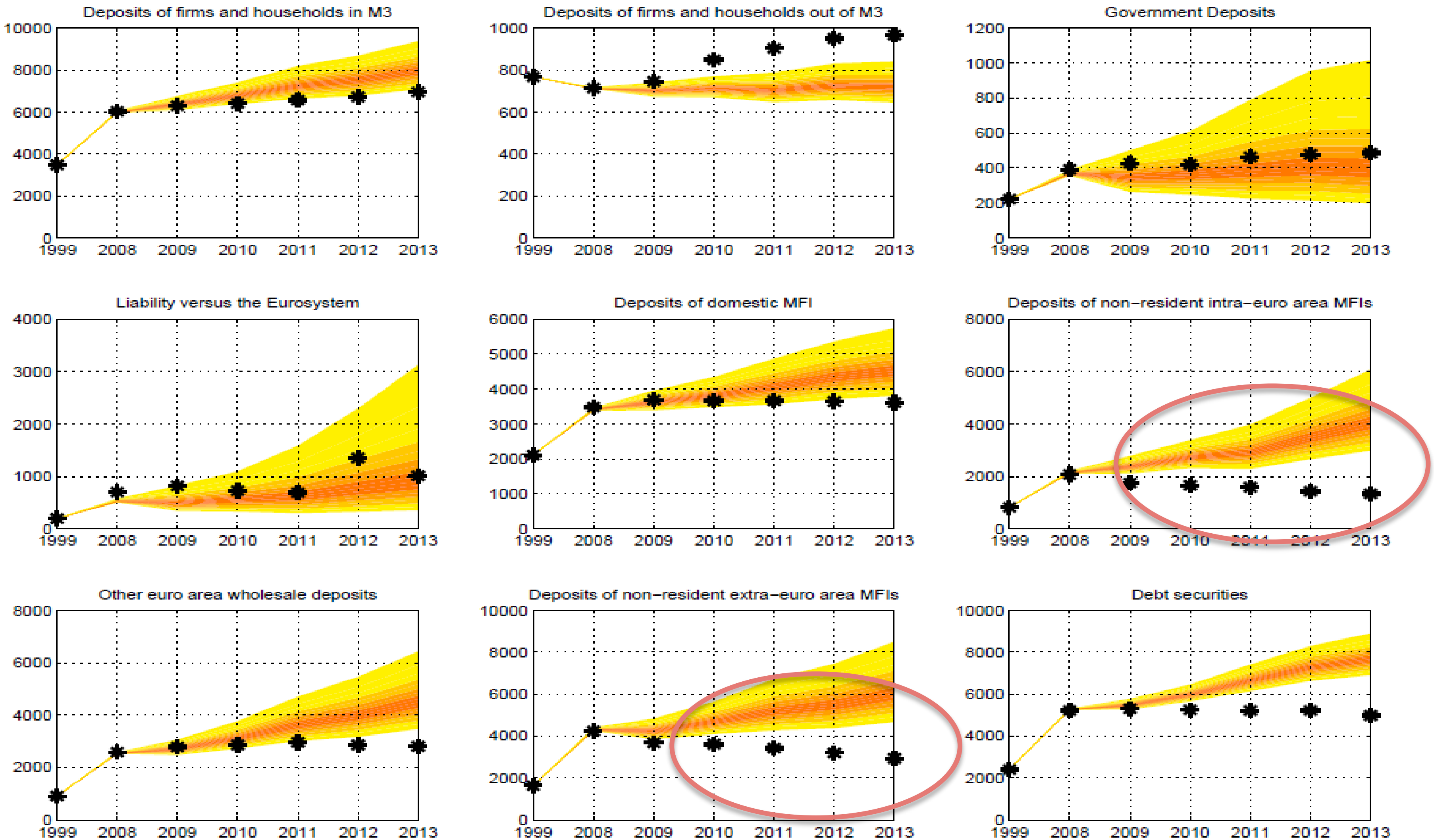
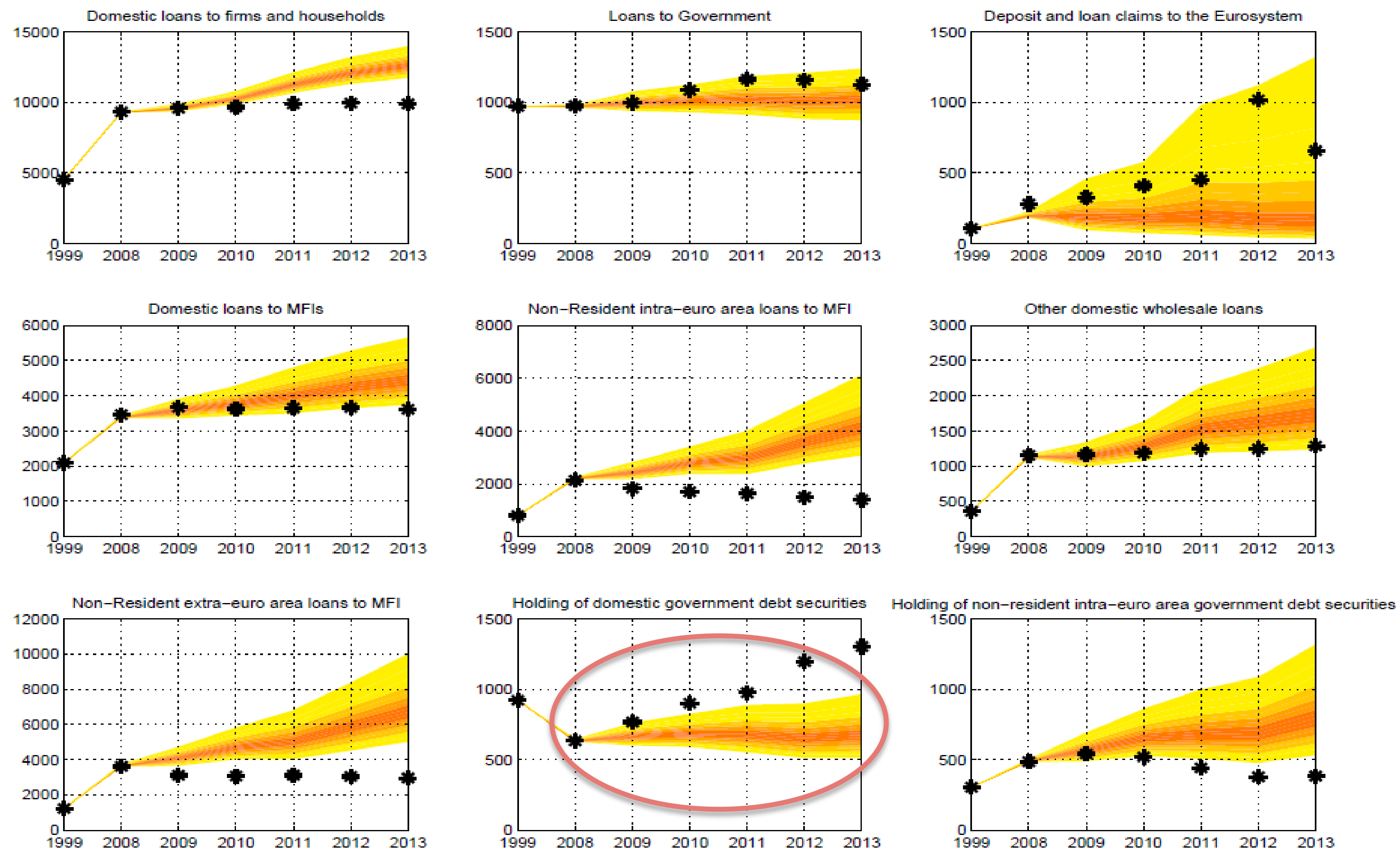


Banks' balance sheets: how unusual since 2008? Assets: shift from loans to domestic government bonds (Colangelo et al, 2013)



Home bias in sovereign holdings by banks

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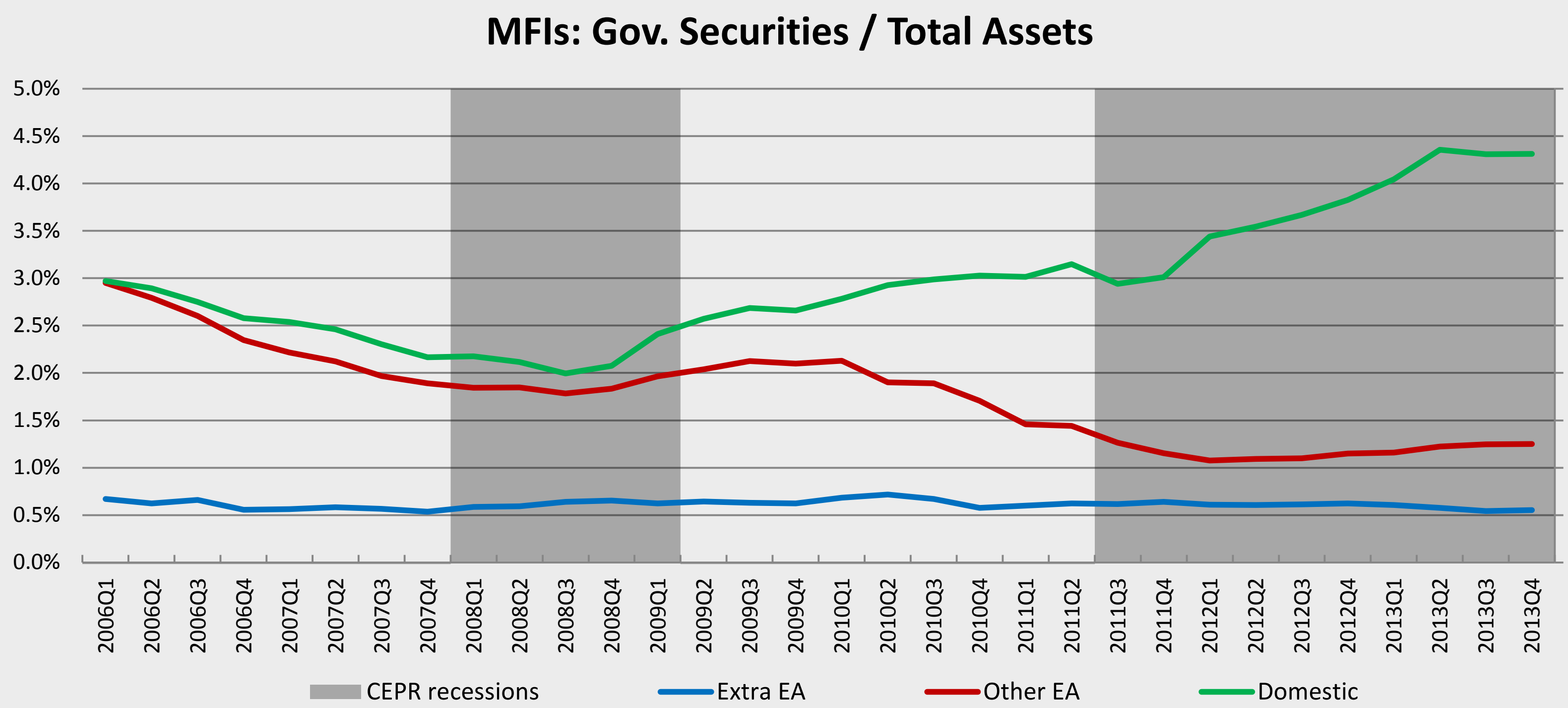
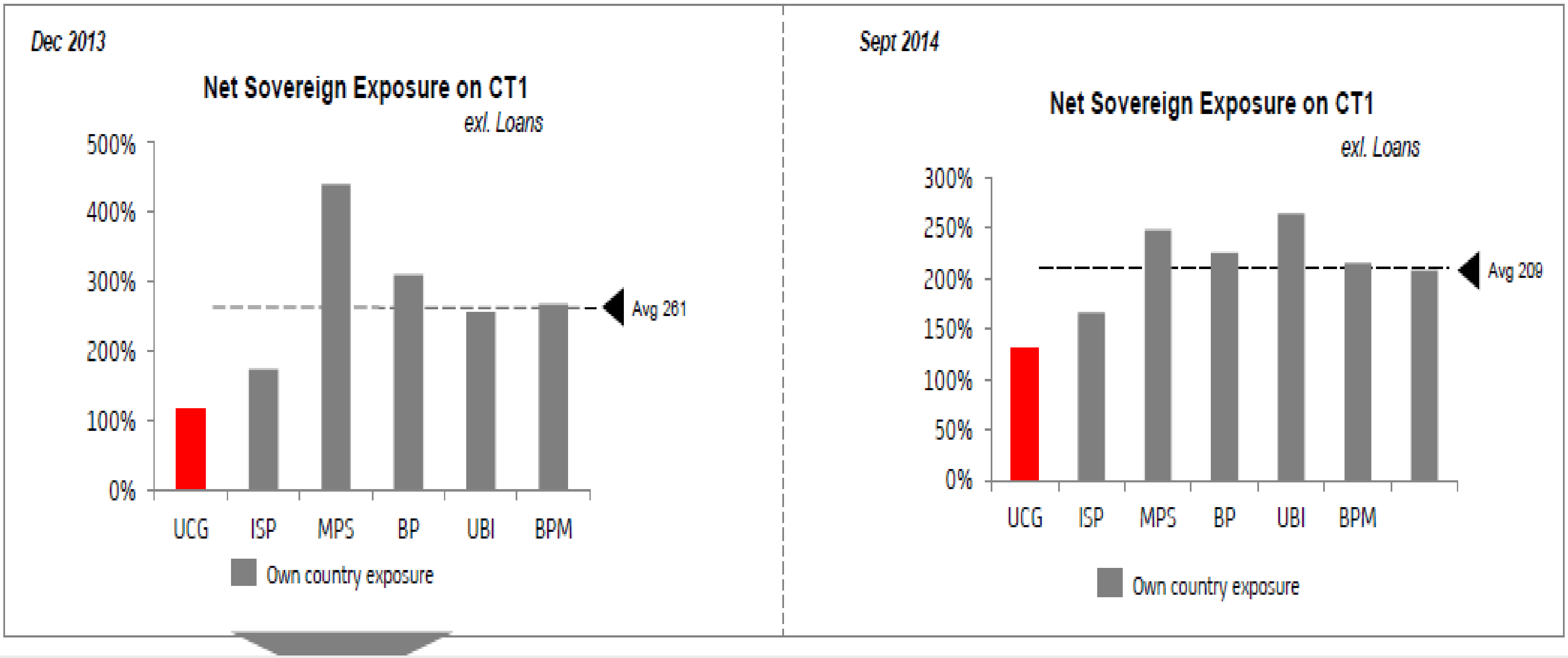


Source: ECB

Italian banks – exposure on own sovereign



Diabolic loop mechanism well understood - yet ….

… little has been done to avoid it

- This is worrying because the solvency of sovereigns is by no means assured
- Sustainability calculations in particular for Italy are worrisome
- The market is disregarding these doubts because of the perceived guarantee provided by the ECB. But were the doubts to return on the market, yields could quickly increase again, hitting hard the balance sheets of banks

Three factors

1. Dismal prospects for NGDP growth leading to debt sustainability concerns
2. The nature of the monetary union means that in any crisis, banks have a strong incentive to bias their holdings towards their own sovereign, dramatically intensifying the diabolic loop and thus the systemic risk
3. The diabolic loop, which was at the core of the uniquely European second recession, has not disappeared as the concentration of their own sovereign paper on banks balance sheets is as high as ever

What to do?

- Need to force the banks to diversify the geographical origin of the sovereign fixed income portfolio
- For the functioning of the EMU it is crucial that banks have a diversified portfolio of sovereign debt
- This can be done with a mixed of "carrots and sticks" that will both strengthen substantially financial stability and also would make sovereign QE more likely to be effective

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- The ECB can achieve the desired diversification by announcing that, in the medium term, for sovereign bonds to attain a risk free weighting, they will have to be held by banks in some given fixed proportions (eg holding each country debt in a proportion equal to its share in Eurozone GDP)

- Similarly, the liquid assets requirements in the new `liquidity coverage ratio' could only be fulfilled through holdings of sovereign bonds in these same fixed proportions

- Finally, the ECB would also announce that for monetary policy purposes it would buy and sell country bonds in a package equal with country debt shares again equal to GDP shares

We expect financial markets to start working immediately towards the issuance of synthetic risk free assets in these proportions

Advantages

- It reduces substantially the geographic bias in the flight to safety, as the safe asset would be (regulatorily) a Europe wide one
- It eliminates the moral hazard that the “risk on/risk off” mechanism induces: governments CAN default in this world, as the banks are protected from the fallout—markets will thus monitor the governments instead of second guessing the (bailout) intentions of the ECB
- it eliminates the diabolic loop, since a sovereign in trouble does not jeopardize its own banks
- It reduces geographic segmentation of the Eurozone markets
- It creates a large safe asset potentially to be targeted by QE

It is important to emphasize here that this synthetic debt would not involve any risk sharing among different governments or any debt mutualization : each government would continue to issue its own debt and face its own interest rates in the market.

Issues

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The debt so issued would NOT BE a safe asset, as it would include debt from all countries including some whose debt sustainability is questionable

Our solution:

The ECB could lead the markets to create this security regulatorly. It could say *"only the senior tranch of the security so produced can receive an AAA rating and be counted as risk free for the purposes of the risk weighting and liquidity coverage ratio calculations."*

An alternative solution is *securitization* and was proposed by Brunnermeier et al, 2011: they suggested that a synthetic risk free asset (what they call the "European Safe Bonds or Esbies") could be created by a European Debt agency as the safer tranch of a synthetic security with the shares above. Again, banks would only be allowed to count as risk free this security

In our proposal no need for debt agency – market solution

Costs in the transition – "back of the envelope calculations"

1. Impact on the price (and thus on the interest rate) of peripheral debt
2. Impact on bank profitability, since banks are the ones currently holding the (relatively) high yielding debt

Back of the envelope calculations – Italy: the size of the new excess supply of Italian debt after a switch away from the domestic bias depends on how much of their assets they would choose to solve in the new "generic synthetic bond"

- Suppose that European banks would hold around 2tn of their assets in this synthetic bond, out of a total balance sheet of approx 3 times the size of the Eurozone GDP
- Since Italy is around 15% of Euro area GDP, EZ banks holdings of safe assets would amount to around €300 bn Italian bonds
- Italian banks currently hold 10% of their assets in Italian bonds, and assets are 2.65 times Italy GDP thus 10% of 2.65*1.5 is approximately €400bn

…….. Therefore

- the magnitudes are close enough relatively to the total supply (recall total outstanding Italian debt is around €2tn) that we would not expect distressed selling or undue pressure on the prices

Consider now the impact on banks profitability

- The key impact here is that on the net interest income lost by replacing say Italian debt yielding 2.5% on average with a basket of Eurozone debt paying 1.5% on average
- If banks have 10% of their assets on these securities, then their return on assets will drop by 15 basis points. Although not trivial in the current environment (where banks margins are tiny and actually ROAs have been negative recently) banks should be able to absorb this
- Partly compensating it, the diversification of the sovereign bond portfolio may induce a "re-rating" whereby the risk premium associated with their stock is reduced.

Conclusions

- We are by no means done with the Euro crisis

- Lots need to e done but part of the solution must be to make the balance sheets of banks more robust, thus also reducing risk posed to sovereigns

- GR proposal suggests undertaking together a Quantitative Easing exercise with a regulatory change in the risk weights and the treatment of liquid assets by banks