REBRANDING CAPITAL MARKETS UNION: STATUS QUO AND BACK TO THE DRAWING BOARD

SESSION 2. INCREASING PRIVATE RISK-SHARING THROUGH A EUROPEAN SAFE ASSET

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BNP PARIBAS

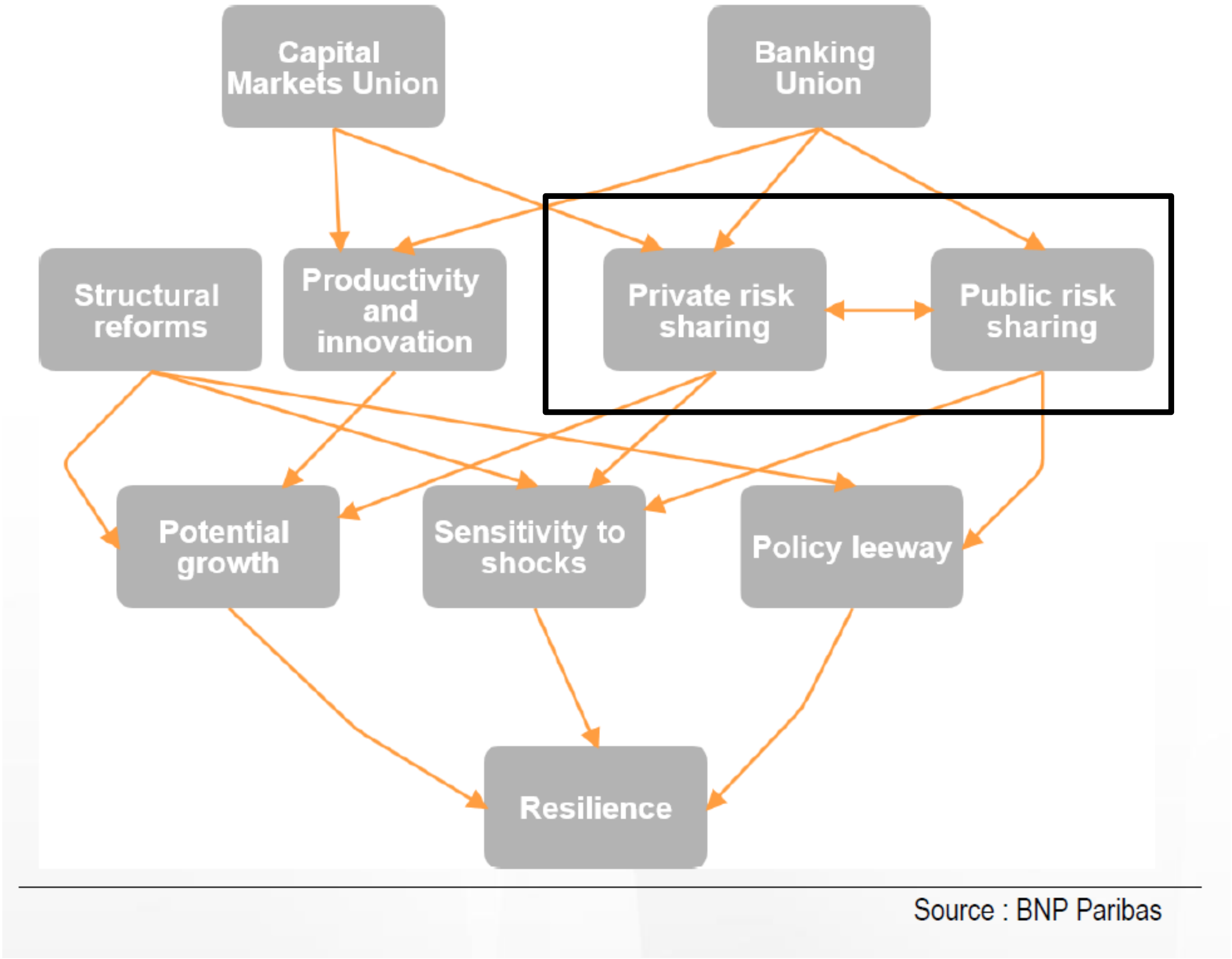
The bank for a changing world

Risk sharing

	Cross border	Domestic
Private	Asset channel Funding channel Labour market channel	Savings channel Credit market channel
Public	Transfers Temporary funding Rainy day funds Union-wide countercyclical policy	Countercyclical policy Automatic stabilisers

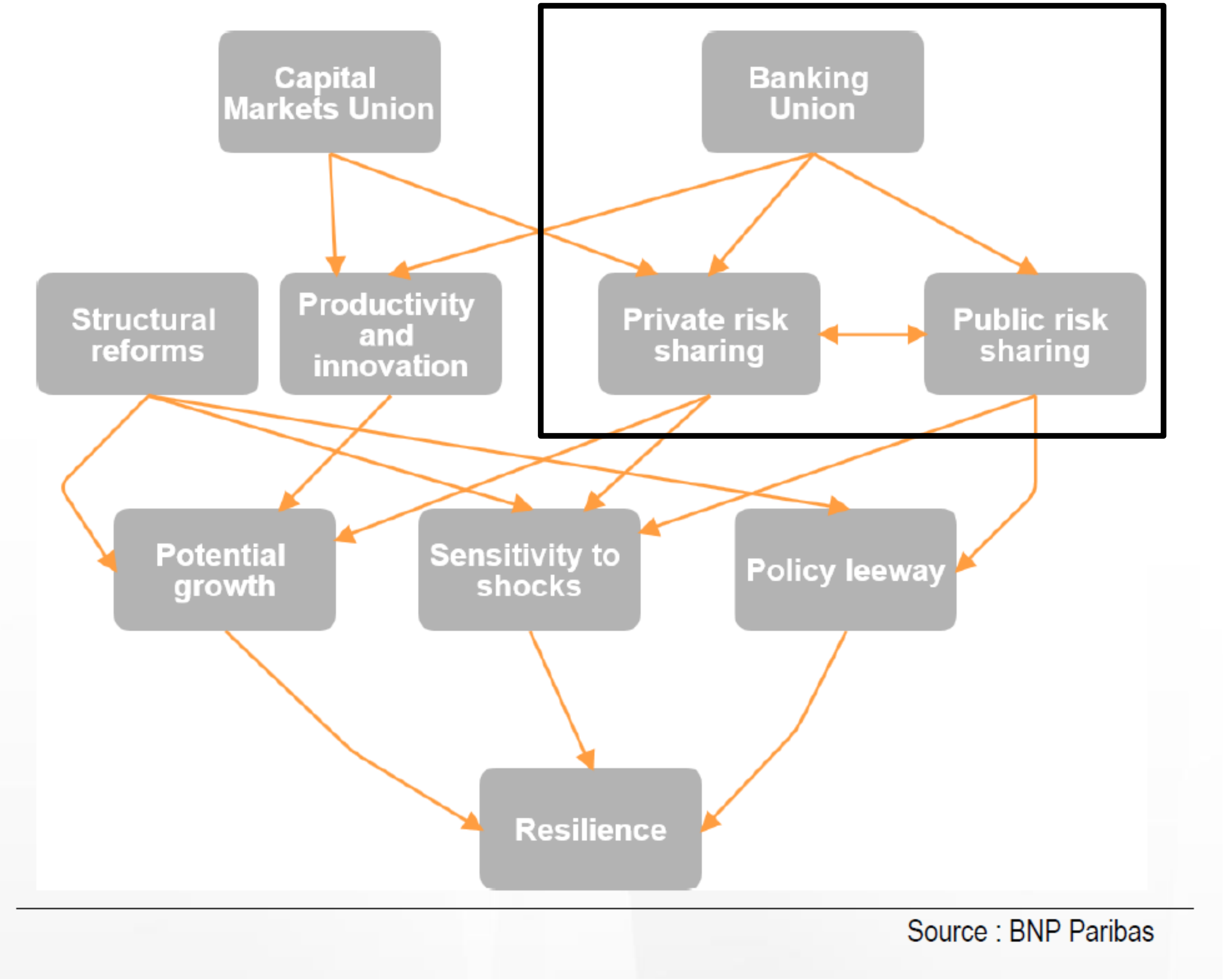
Source: William De Vijlder, Risk sharing in the eurozone: which way forward?, Conjoncture, BNP Paribas, October 2018

Drivers of economic resilience



Source: William De Vijlder, Eurozone: strengthening resilience, Ecoweek, BNP Paribas, 23 November 2018

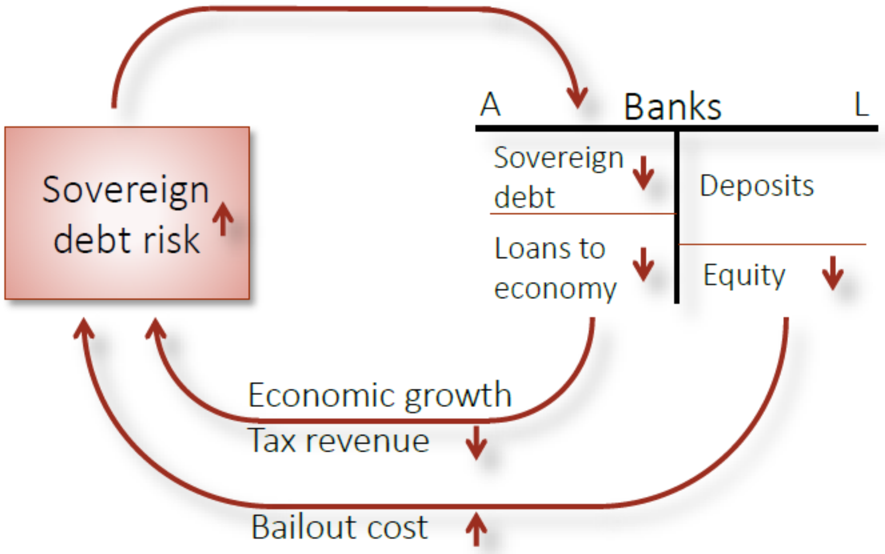
Drivers of economic resilience: feedback loops



Source: William De Vijlder, Eurozone: strengthening resilience, Ecoweek, BNP Paribas, 23 November 2018

Feedback loop => need for safe asset

Figure 2: The sovereign-bank diabolic loop



Note: Figure depicts the diabolic loop between sovereign risk and bank risk. The first loop operates via a bail-out channel: the reduction in banks' solvency raises the probability of a bail-out, increasing sovereign risk and lowering bond prices. The second loop operates via the real economy: the reduction in banks' solvency owing to the fall in sovereign bond prices prompts them to cut lending—reducing real activity, lowering tax revenues, and increasing sovereign risk further. Source: Brunnermeier et al. (2011).

Source: ESBies: Safety in the tranches, ESRB Working Paper n°21, September 2016

The merits of a safe asset in EUR

1. Risk sharing (risk avoidance → avoiding doom loop risk)
2. Financial stability
3. Enhancing fluid functioning of markets (collateral)
4. Facilitating pricing of other assets
5. Attracting foreign investments (deep, liquid markets)
6. International role of the euro

"Are sovereign-bond backed securities (SBBSs) the right option? What are the alternatives (European Safe Bonds, national tranching, E-bonds, ESM bonds)?"

Two extremes

Joint liability

- Public risk sharing
- Risk is reduced: sharing reduces likelihood of tail events and associated spillovers
- Moral hazard problem
- Time consistency problem (political/popular support *ad infinitum*?)
- How to impose two-way commitment (fiscal discipline and fiscal support) in a democratic and credible way?

No joint liability

- National tranching
- Joint tranching (ESBies, SBBS)
- Risk transfer
- Does risk transfer reduce likelihood of tail events?
- Does it meet other objectives/requirements of safe assets?

ESBies, SBBS: questions (1)

1. Who buys what? (Senior tranche, junior tranche, (non-tranched*) national debt)
2. Are there enough buyers with an available risk budget (otherwise: crowding-out)
3. What is the liquidity of the different instruments?
4. How to introduce ESBies when ECB balance sheet is still huge?
5. Can enough safe assets be created via ESBies when ECB capital keys are used?
6. Do ESBies hinder future QE operations?
7. Would ECB buy senior, junior or senior + junior?
8. Juxtaposition of senior and junior tranche creates barbell. Does yield (level and volatility) of junior tranche influence pricing of debt of non-sovereign issuers?
9. Why buy junior tranche when components can be bought individually? Investor doesn't want to lose the diversification free lunch so yield on junior tranche should be in line with weighted average of the components. Junior tranche implies packaged investment (by construction exposed to all markets) which may deter investors
10. Packaged investment may increase contagion risk (concern about one country causes selling of junior tranche which impacts all markets)

*non-tranched = not being bought by the securitisation vehicle

ESBies, SBBS: questions (2)

11. Will non-tranched national debt be used to hedge single country tail risk exposure from the junior tranche? Will this impact the pricing of the senior tranche?
12. Trade-off between non-tranched national debt liquidity and provision of safe asset via ESBies
13. Who arranges ESBies: public sector, private sector? Does it make a difference?
14. Impact on profitability of banking system in countries with high spread versus Bunds? Will these banks reduce their risk exposure or shift their risk exposure?
15. Is junior tranche country allocation very different from commonly used benchmarks and what issues does this create?

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