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Securitising sovereign bonds

Prof. dr. E.P.M. Joosen

During the so-called 'sovereign' crisis, which occurred in 2011, German sovereign bonds in particular were a safe haven for investors. The transition by investors to German treasury bills was stimulated by concerns relating to the health of the economy of many Member States in the Eurozone, with negative consequences for the valuation of bonds issued by these countries. These concerns were partly fuelled by skepticism regarding compliance with the budgetary discipline agreements within the framework of Economic and Monetary Union (hereinafter: EMU). For Member States with a sound budgetary discipline, the transition to German treasury bills also meant an upward price correction for the obtaining of funding on the capital markets compared to German treasury bills. Dutch bonds, for example, were a fraction more expensive than German bonds despite a solid implementation of the budget agreements in the EMU.

Since the euro is a reflection and an average of the economic position of all the euro countries together, the currency is undervalued in countries such as Germany and the Netherlands and overvalued for other euro countries. This leads to a movement towards German assets, including their sovereign bonds. Moreover, the transition to German treasury bills led to pressure on the liquidity of such bonds, which is limited by the funding needs of the German government. Within the context of this issue, debates were conducted on the (political feasibility of) issuance of so-called 'Eurobonds': instruments for which the Member States of the EMU are jointly and severally liable and with a centralized 'treasury' for the organization of issues, 'debt service' etc. Until Europe (or at least the Member States of the Eurozone) have a common budget and a common minister of Finance and have made agreements on numerous matters, such as the Risk Reduction package (see more about this in my last article in *FR* 2017, no. 7/8), the issuance of Eurobonds will not be addressed. In addition, the precondition for further deepening EMU is that all countries maintain budgetary discipline independently, without the help of European institutions.

Because, an efficiently functioning market will therefore not be established anytime soon, it has been investigated whether an alternative can be created for such Eurobonds, so that the dependence on German treasury bills for the availability of 'safe assets' can be reduced. In 2016, the board of the European Systemic Risk Board (ESRB) installed the High-Level Task Force on Safe Assets that has started to investigate an alternative. At the same time, a series of publications has been produced in the academic literature in which the subject has been examined more closely. Among other things, an in-depth study was conducted into the pricing of EMU Member States during the 'sovereign crisis'. The study exposed the effect of undervaluing solid sovereign bonds as discussed above.[1]

In January 2018, the High-Level Task Force published a voluminous report entitled 'Sovereign bond-backed securities: a feasibility study'. This report describes the securitization of a diversified pool of sovereign bonds of Member States of the Eurozone ('SBBS-bonds') as an alternative to issuing Eurobonds. Such SBBS-bonds should be broadly structured in the same way as transactions in which (commercial) loan portfolios are packaged and placed in a securitization. The starting point is that private parties arrange such

[1] See: Ad van Riet, 'Addressing the safety trilemma: a safe sovereign asset for the Eurozone', February 2017 ESRB WP-Series no. 35.

securitizations, and thereby acquire and package the sovereign bond portfolio of the various Eurozone Member States in the securitization.

Partly to promote the diversification of the portfolio and to create the right creditworthiness profile, a distinction will be made between 'strong' and 'weak' Member States. The starting point is therefore a 'private-law' structure, with a Special Purpose Vehicle (hereinafter: SPV) which houses a portfolio of sovereign bonds that covers the SBBS-bonds issued by the SPV. As a result, banks could also securitize their own holdings of sovereign bonds and thereby indirectly invest in bonds of 'weaker' Eurozone Member States, because despite the 'theoretical' equal risk weighting of 0% for all sovereign bonds of Eurozone Member States, there is great reluctance to invest in bonds from the less strong Member States in the Eurozone.

The feasibility study of the High-Level Task Force is based on fundamental research into the expected value development of SBBS-bonds, in particular to be able to compare this value with German treasury bills (the so-called spread). Based on this research, it was determined that the AAA-senior tranche of SBBS-bonds will have at least comparable value development as German Treasury bills, but may even perform better in terms of price formation, because the AAA-senior tranche would only suffer losses after the subordinated tranches have suffered losses. As far as the (subordinated) mezzanine and junior bonds are concerned, they are expected to have a worse 'creditworthiness' than the AAA-senior tranche, but that in view of the interest paid on such bonds a significant, liquid market for this security will exist.

One of the components of the feasibility study concerns the 'regulatory treatment' of the SBBS-bonds from the perspective of the prudential supervision of banks, insurers, investment firms, AIFMD- and UCITS-investment funds. The AAA-senior tranche of the SBBS-bonds will, after amendment of relevant European legislation, obtain a '0% risk weight' and therefore obtain in fact the same risk weighting as sovereign bonds. This particular proposal must be seen as a political intermezzo, in anticipation of breaking open the discussion to grant the sovereign bonds of the various European countries different risk weights. This is different now, because each country currently has an equal (0%) risk weight, but there is a consensus that such an equalization does not do justice to the strongly deviating profiles of creditworthiness of the European countries. With the introduction of SBBS-bonds, it will also be easier for countries with a weaker economy to accept a new estimate of the credit risk of their bonds. The pooling of risks in an SBBS securitization creates an opportunity to create a mixed portfolio of sovereign bonds with different creditworthiness profiles.

The proposal also achieves that these securities are regarded as 'safe assets' which, from the perspective of liquidity supervision, can constitute a suitable alternative for fulfilling the obligation to have good quality assets (read cash, sovereign bonds) available, to be able to cope with any outflow of liquid assets. But also for life insurers and pension funds SBBS-bonds will be a suitable alternative for long-term investments and adhering the ‘prudent person’ rules for investment policy.

Finally, a far-reaching recommendation is also made from the perspective of civil law by the High-Level Task Force. For the sake of comparability for investors, the Taskforce proposes to uniformize the governing law for bonds, for transaction documentation, for law that applies to the SPV, for additional agreements in the context of the securitization (such as the swap agreements, liquidity support, servicing agreements) and so on. Focusing on a program for Member States of the Eurozone, and considering the developments in the context of Brexit, it would not seem logical that English law is applicable for such SBBS-Bonds. This means that a choice will have to be made for the law of one of the Eurozone Member States. Should it be

investigated whether Dutch law can be put forward as a (relatively) neutral choice for such structures? It is not obvious that, for example, German law or French law will gain broad support within the group of the Eurozone Member States, or at least that could lead to politically complicated situations.

For that reason, it would be extremely interesting if the Dutch legal practice were to make efforts to advance this in the European consultations. Perhaps this also gives a new impulse to the, in my opinion, urgently needed thought about the governing law for financing transactions after Brexit, because the almost automatic choice for English law for transactions between parties within the Eurozone has run its course. This is due to the expected complications in the enforceability of transactions governed by English law if there is a 'hard' Brexit without agreements about mutual recognition of court decisions.