

## Partial sovereign bond insurance by the eurozone: A more efficient alternative to blue (Euro-)bonds

**Hans-Joachim Dübel**

**No. 252, August 2011**

### Abstract

*'Blue' or Eurobonds guaranteed via joint and several liability by the eurozone member states have been proposed by Bruegel, the Brussels-based think tank, as a key tool to stabilise and structure the eurozone sovereign bond markets. However, as current events show, a second key feature of the proposal – their limitation in volume to 60% of GDP – will be untenable in times of financial crisis. It carries the risk of exploding marginal costs of funds to those sovereigns facing rapidly rising debt levels and forcing them to issue 'red' bonds on their own standing. Rapidly rising fund costs would quickly drive them out of the bond market and into the blue bond-issuing Eurozone Stability Mechanism (ESM). Therefore, under the current proposal, in practice all sovereign bonds issued in the eurozone, regardless of ex-ante GDP limits, would have to be assumed to be blue bonds – an outcome that is fraught with moral hazard.*

*Partial insurance of sovereign bonds by the ESM that avoids such ex-ante volume limitations is a more efficient alternative. Sovereign bonds would embed a predetermined percentage of junior debt that would be spun off as a marketable bond on the ESM application day, while the remaining senior debt would be amortised as scheduled. Such 'junior' bonds could be subject to a restructuring or haircut under an emergency fiscal adjustment programme devised by the ESM. The insured portion, the 'senior' bond, would stabilise investor balance sheets by setting a floor under sovereign bond prices – both ex-ante and ex-post. Additional debt to be issued by the sovereign during a financial crisis would remain partially insured and thus carry substantially lower marginal costs of capital than 'red' bonds. This would enhance the options for the borrower to adopt fiscal measures early and reduce the likelihood of tapping the ESM for primary market funds.*

*Viewed from a political economy perspective, partial sovereign bond insurance is nothing more than a formalisation of what has already been agreed upon. This is the declared policy action of both banks and governments in the current crisis: private sector first-loss participation while avoiding a catastrophic ('Lehman') loss event.*

Hans-Joachim Dübel is an independent financial sector consultant based in Berlin and founder of Finpolconsult, former staff member of the financial sector development department of the World Bank and of empirica, a German housing and urban economics policy think tank. The author thanks Alan Boyce for careful editing and structure.

CEPS Policy Briefs present concise, policy-oriented analyses of topical issues in European affairs, with the aim of introducing the views of CEPS' researchers and associates into the policy-making process in a timely fashion. Unless otherwise indicated, the views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Available for free downloading from the CEPS website (<http://www.ceps.eu>) • © CEPS 2011

## Why blue (Euro-)bonds will not work as proposed

The term 'Eurobonds' has been intensively in the political discussion throughout 2011 as the central tool for stabilising eurozone sovereign bond markets. The most specific proposal so far, advanced by Bruegel,<sup>1</sup> calls for splitting the market along the following lines:

- Blue bonds would be jointly and severally guaranteed by eurozone sovereigns via the future European Stability Mechanism (ESM), or its current precursor, the European Financial Stability Facility EFSF, up to 60% of the GDP of the sovereign-issuing country.
- Red bonds would be issued on the individual sovereign's standing for all sovereign debt in excess of 60% of its GDP. In addition to being unsecured by the ESM (EFSF), red bonds would be subordinated to blue bonds.

### Debt dynamics during crisis renders GDP limits non-credible

I argue that the Bruegel proposal cannot work in a financial crisis if the goal is to limit blue bonds to 60% of GDP or another moderate threshold value, due to typical debt dynamics.

We have seen eurozone member states whose sovereign finances had been well-managed before the crisis rapidly piercing the 60% ceiling. In Spain there was an increase in public spending, a lack of control of regional spending and a decrease of regional revenue in particular (much of which is real-estate related). In Ireland, there was an assumption of private bank debt (implicitly real estate developer debt).

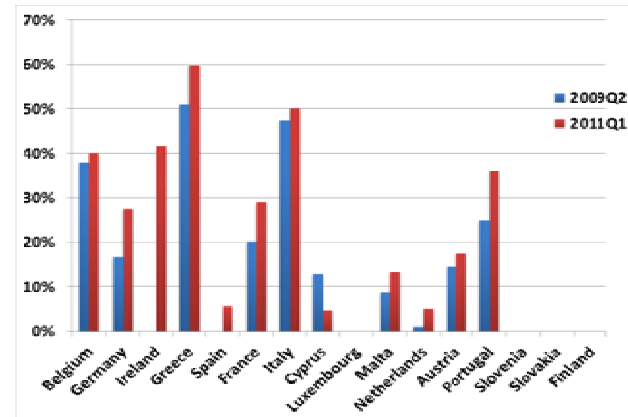
As Rogoff & Reinhardt (2009) have shown, such aggressive short-term sovereign debt dynamics are the classic course of events, and will most likely end in a very messy default.

Figure 1 displays the share of total sovereign debt that is in excess of 60% of GDP ('red bond' debt) for eurozone member states, as reported by Eurostat, comparing the second quarter of 2009 with the first quarter of 2011.

Ireland and Spain are in fact even newcomers in the proposed red bond market. Sovereign borrowers considered until recently as less vulnerable are running high and still moderately increasing ratios

of red debt (such as Belgium and Italy), while others, currently still seen as 'more stable', are quickly expanding into red territory (i.e. Germany and France).

Figure 1. Red bond debt (> 60% GDP), 2<sup>nd</sup> qtr of 2009 vs. 1<sup>st</sup> qtr of 2011, % of total debt issued by sovereign



Notes: Level of government debt in the quarter divided by the sum of current and last three quarters of GDP.

Sources: Eurostat, Finpolconsult computations.

While we are unsure therefore whether a static GDP threshold for sovereign debt is a good predictor of sovereign financial vulnerability,<sup>2</sup> we know for sure that red bonds, being both junior and unsecured, when issued by a sovereign considered as financially vulnerable, would fetch ballooning spreads in times of crisis. The positive impact of blue bonds for such a borrower would therefore be limited to the secondary market, while his primary market will be thrown into turmoil at the worst possible time. This is both an economically and politically impossible outcome, and exactly the reverse of what is needed to mitigate adverse follow-on effects, such as a negative fiscal austerity low-growth feedback loop.

The probability indeed would be high that any formal GDP ceiling would be declared null and void by policy-makers when crisis hits. Alternatively, eurozone members facing steep marginal costs will apply more quickly to the ESM, which is an issuer of blue bonds and is likely to pass on most of their interest rate advantages.

<sup>2</sup> Replacing the sovereign debt-to-GDP threshold by a wider static measure, e.g. including private sector debt, will not lead to a much different outcome. Consider the case of the Netherlands, where a large volume of mortgage debt is targeted to upper middle-class consumers for tax arbitrage purposes. In contrast, low mortgage debt volumes can easily balloon, e.g. when the mortgage instrument is tied to a foreign currency, as in the case of Swiss Franc loans in Austria.

<sup>1</sup> See Delpla & von Weizsäcker (2010).

### ***De facto full insurance creates massive moral hazard***

Because red bonds cannot work in a stressful situation, the distinction between blue and red bonds is an artificial one. In reality, investors will anticipate the outcome during crisis and consider all bonds issued under the scheme as blue, i.e. fully protected by the ESM, with the red bonds being merely a contingent liability.

This would eliminate market discipline almost entirely rather than defining a playing field for the market.

Full insurance perceived by investors renders it more likely that other markets will be 'pegged' to the benefiting sovereign market via explicit or implicit sovereign guarantees, e.g. bank, mortgage (retail) and corporate bond markets.

This eliminates market discipline in additional markets, where far greater options for private sector control exist than in the sovereign market, and at the same time raises potential bailout costs.

The marginal cost of the funds problem described will become more acute, as the surpassing of a specific sovereign debt-to-GDP level becomes more likely when other bond markets are being simultaneously guaranteed and lose discipline.

Necessary fiscal controls (joint fiscal policy) for a full insurance model are large, and short-term implementation is out of question in the eurozone, let alone the EU. Not even the US, which is far more advanced in fiscal (and political) integration than the eurozone, has a full insurance model in state finance. Fiscal coordination between states in the US is rather indirect, via copying of fiscal rules and transfer policy arrangements, and state debt is not explicitly guaranteed by the federal level.

To support a full insurance model, a very large ESM, established as a quasi-bank, will be required, which may prove very hard to control in day-to-day operations.

It is finally worth noting that the financial situation that an unlimited blue bond would create is exactly the same as the eurozone situation of the 2000s, when spreads of sovereign bonds to Bunds already were minimal. This caused substantial delay in addressing fundamental fiscal and economic problems, and even deterioration.

### **Partial sovereign bond insurance by the eurozone ('eurozone bond insurance')**

#### ***Basic concept***

The fundamental alternative to full insurance with a non-credible volume limit is partial insurance without a volume limit. The goal is to moderate the marginal cost of funds in a crisis situation while keeping them sufficiently high in a non-crisis situation, in order to keep incentives for sound fiscal and economic management intact and discourage the described pegging of other bond markets.

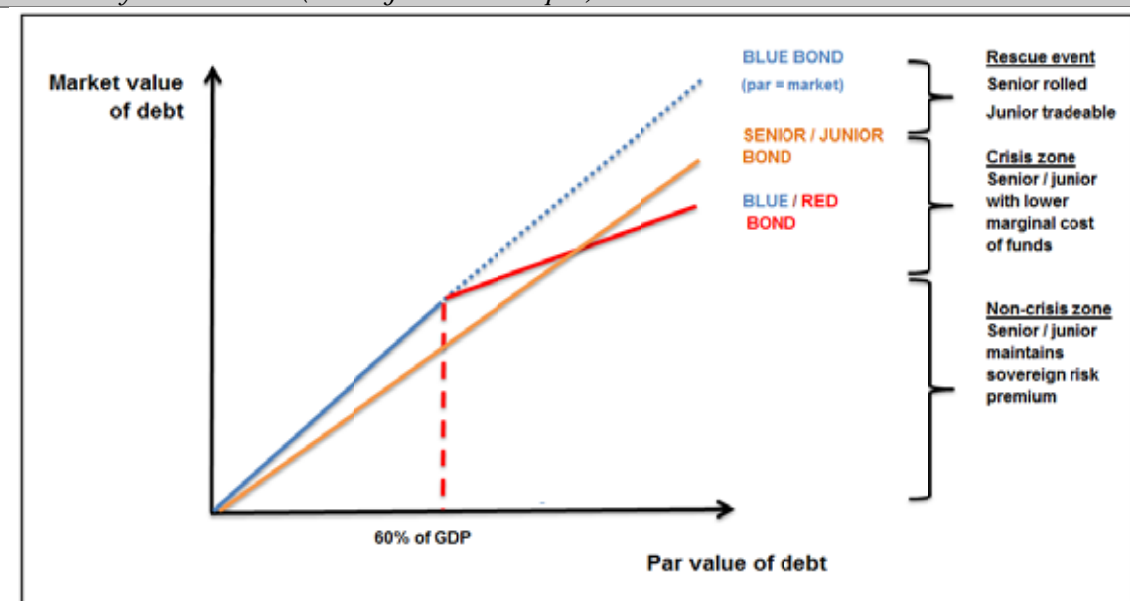
Partial insurance could come in highly diverse forms, as a review of products in the existing bond insurance market shows. The particular form proposed here would be a partial insurance wrap of both principal and interest by the ESM. However, as a variant to standard partial wraps, we propose to endow the protected bond with a 'dormant' senior-junior structure. Dormant means that a 'junior' bond – the principal/interest not protected by the ESM – is created if and when the bond insurance is called.

The trigger date is when the ESM is tapped as the lender of last resort by the borrower. The entire yield curve of the borrower is treated equally. For non-maturing bonds, the call leads to the creation (split) of the (tradeable) junior bond and a senior bond to be serviced and amortised by the ESM as scheduled. Tradeable junior bonds serve to better manage the balance sheet risks of investors and attract additional investor classes interested in speculative assets.

Junior bonds could be restructured (e.g. with payouts linked to GDP growth) or given a haircut under the fiscal adjustment programme to be determined between the ESM and the borrower. As with Eurobonds, ESM-sponsoring governments would be provided with ample control rights in return for their partial sovereign bond guarantees.<sup>3</sup> In particular, a set of fiscal (and financial sector) policy criteria – in addition to other signals, such as rating or spreads – could serve to specify and differentiate the necessary insurance premiums to fund the scheme.

<sup>3</sup> Whether to continue to use the term 'Eurobond' for a partially ESM-insured sovereign bond is a matter of communication with the public. Much positioning against or in favour of Eurobonds has taken place in the European political sphere, with little reference to specifics.

Figure 2. Market pricing of Eurobonds (blue/red bond split) vs. sovereign bonds partially insured by the eurozone (senior/junior bond split)



Source: Dübel/Finpolconsult.

### Pricing of partially insured sovereign bonds during crisis, compared to blue/red bonds

The partial bond insurance concept using the senior/junior bond split as described avoids the cliff-edge effect of a 60% GDP ratio while still providing investors with explicit catastrophic risk protection. This leads to drastically reduced marginal cost of funds, especially during crisis. I have represented these dynamics in a highly simplified manner in Figure 2 above.

The blue/red bond split creates a kinked curve for the market value of total debt. Below the 60% GDP threshold, the value of debt is always par (ESM current coupon levels), implying that no sovereign risk premium is charged. Above the 60% threshold, however, as additional debt is issued on the basis of sovereign standing only, the additional market value of additional debt is considerably below par. Marginal bond prices (rates) collapse (jump) in discretionary form, establishing a financial accelerator.

In contrast, under the partial insurance senior/junior bond concept, a sovereign risk premium will be charged at almost any level of debt (including very low debt levels), i.e. for a higher-risk sovereign the debt trades almost always below par (ESM). The continuing existence of a sovereign risk premium will assist collective eurozone efforts to improve fiscal and financial market discipline, even below a debt level of 60% GDP, where the blue bond would treat a high-risk sovereign artificially as low-risk.

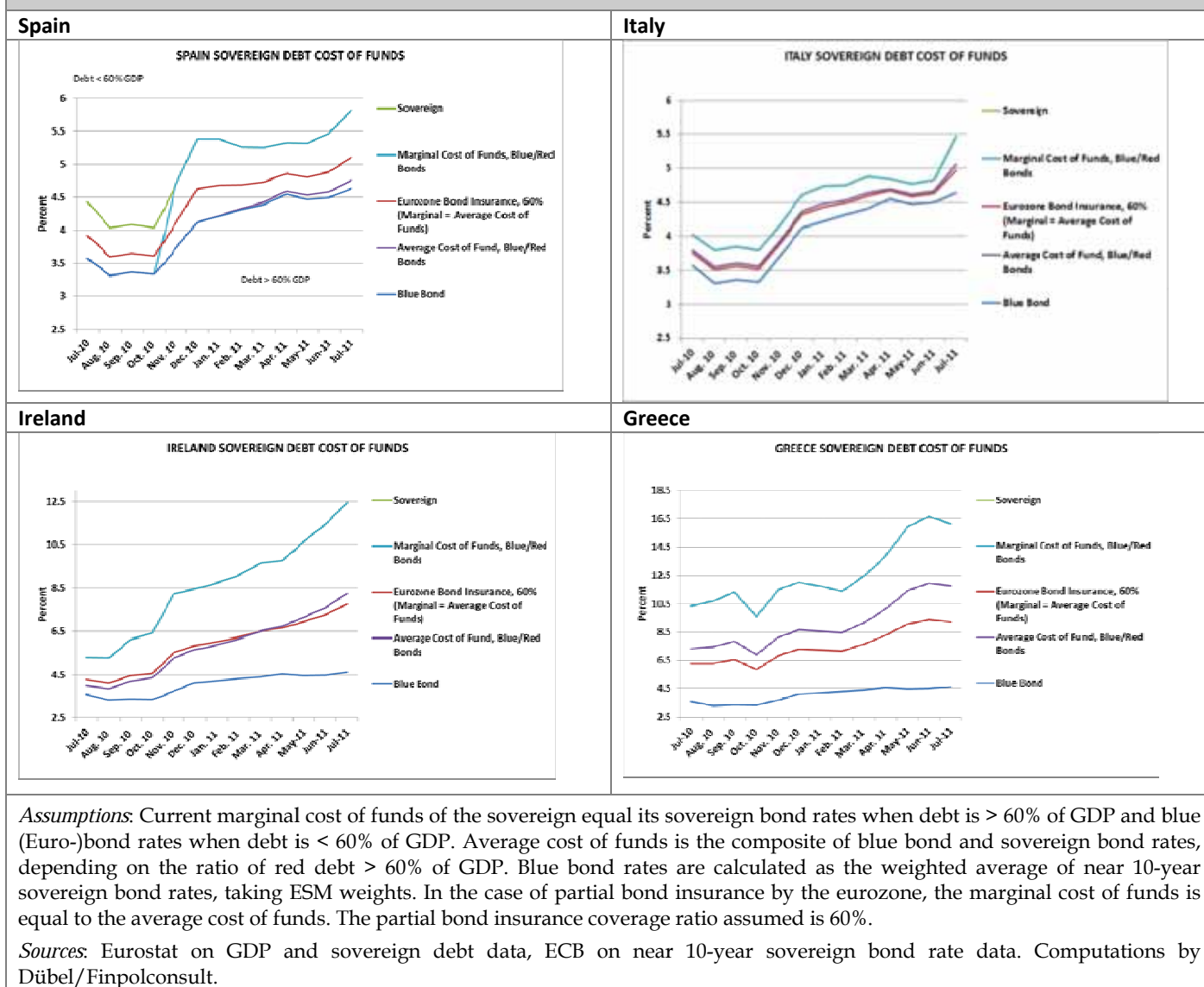
However, *additional* debt will be priced the same, or only marginally higher as the markets will price in an increased probability of the bonds being split, while catastrophic risk protection remains in place (potential convexity not shown in the figure, which uses a straight line). Marginal bond prices (rates) broadly equal average bond prices. The likelihood of tapping the ESM in the crisis zone, when debt starts to exceed 60% of GDP, will be far smaller as the borrower gets additional room for manoeuvre for strategies reducing debt or debt growth. Insurance premiums could still be increased in this room for manoeuvre at an early stage to enhance a borrower's willingness to adopt sufficiently effective measures.

Figure 3 presents the development of the average and marginal cost of funds of four eurozone member states for the two alternatives in an historical interest rate simulation based on Eurostat/ECB data for 2010 and 2011. The assumptions made clearly ignore some key issues, such as implicit eurozone protection already implied in current sovereign bond rates, the pricing impact of the proposed subordination of red bonds, and in particular the maturity structure of existing debt.<sup>4</sup>

<sup>4</sup> The maturity structure will massively affect the average cost of funds, but less so the marginal cost of funds. Intuitively, the sensitivity of average cost of funds to the term structure will be less in the partial insurance proposal, where marginal and average costs are moving closer to each other than in the blue/red bond proposal.



Figure 3. Simulation of interest rates of Eurobonds (blue/red bond split) vs. partial sovereign bond insurance by the eurozone (senior/junior bond split): The cases of Spain, Ireland, Italy and Belgium 2010-11



### The results of the simulation are as follows:

**Spain:** As Spain broke through the 60% GDP debt ceiling in November 2010, its marginal cost of funds under the blue/red bond proposal would have risen from 3.35 to 5.4%, a 60% increase in interest costs. The marginal cost of funds of a 60% partially Eurozone-insured bond would have been only 4.65% in the same month. In the later course of events, the interest-rate spike in the second quarter of 2011 would have been only partially transmitted under the partial insurance approach: at spike sovereign rates around 6%, marginal rates would have remained a full percentage point lower.<sup>5</sup> Given that Spain

remained close to the 60% debt ceiling, the average cost of funds of the blue/red bond proposal would have stayed below the partial insurance proposal.

**Italy:** With debt during the period always in excess of 60% of GDP, the marginal cost of funds (red bond) was always higher than the average cost of funds, including blue bonds. The marginal cost of funds of ESM-insured bonds at the 60% coverage ratio would have been some 30-50 bp lower, with the greater difference arising during the July 2011 crisis. Given the high debt levels, the

<sup>5</sup> It could be argued that sovereign secondary market rates embed a probability of implicit ESM protection and 'clean' sovereign rates should even be considerably higher. This

argument holds more credibility for the smaller states, in particular of course those that already are with the EFSF (ESM). This strengthens the case against using red bonds in a crisis situation.

average cost of funds for both proposals would be roughly the same.

*Ireland:* As with Italy, the 60% ceiling was pierced with the banking crisis in the third quarter of 2009. It is worth noting the vast marginal cost of funds' advantage of the partial insurance solution of a full 400 bp, resulting from the massively widened sovereign spread. Red bonds would have been out of the question for Ireland, which has tapped the European Financial Stability Facility (EFSF). Importantly, under the partial insurance concept, the critical threshold rate of 7% would have been pierced only very late, in May 2011. Positive feedback effects of the partial insurance coverage might even have avoided drawing on the EFSF.

*Greece:* Facing large debt levels, issuing red bonds in the Greek case would have been as non-feasible as in the Irish case. We note also that the average cost of funds of the blue/red bond combination would have exceeded the partial insurance average cost of funds by some 100-200bp, since debt levels are so high. Again, the marginal cost of funds of a partial insurance solution would have been far lower than red bond rates, and the critical 7% level would have been pierced far later. In the Greek case, my term structure assumptions (see footnote **Error! Bookmark not defined.**) appear particularly restrictive, as the sovereign had preferred long-term bond issues that dampened the rise in the average cost of funds. In combination with partial insurance reducing the marginal cost of funds, this might have substantially increased the room for avoiding tapping the EFSF.

### General cost-benefit considerations

- *Calibrated burden-sharing of investors in an ESM resolution.* When a new partially insured bond is issued, it already entails an adequate structuring for the resolution case. The junior bond is split away on the rescue event date from the senior bond, e.g. at a ratio of 40-60%, as in the simulation. It only then becomes subordinated, to both the senior bonds it was split from, and all new bonds issued. Maturity, amortisation and interest rate conditions of the junior bond can be changed by the ESM in interaction with the borrower to support the fiscal adjustment programme. No separate agreement with creditors will be

needed, even though the concept can be reconciled with the proposed collective action clauses for bonds issued from 2013 onwards.

- *Adequate minimum protection of investors.* The senior bond portion is amortised by the ESM under its contractual conditions without further conditionality (i.e. public discussion/political risk). This sets a floor under investor losses and safeguards an important volume of his liquidity needs. It is paramount to avoid another Argentina or Lehman event with bottomless senior bond prices and illiquid markets in them, in order to stabilise the bond market as a whole. Regulatory benefits for senior bonds would stabilise the capital situation of banks and insurance companies hit by an event. Regulatory capital differentiation would be focused on the junior bond, which those institutions can dispose of, but in exchange for a write-down.
- *Freedom to dispose, beneficial speculation.* The junior bond split from the senior bond on the rescue event date can be sold by the investor at the most convenient point in time, or kept to its restructured maturity. Credit funds and other risk-takers in the market will appreciate those bonds as convenient leveraged vehicles, requiring less funding, to take a position in the underlying credit event. The current 'mezzanine' problem – a dry-up of institutional investor liquidity in the middle spread range where interest by credit funds is still low – is being avoided.
- *Avoids triggering rating and credit default swap (CDS) default clauses.* The junior bond split from the senior bond on the rescue event date will still be 'performing' at that point in time, as will be, in any event, the senior bond. Only upon later restructuring will rating or CDS events be triggered. This will reduce but not eliminate another financial accelerator.
- *Minimisation of distortions across the sovereign yield curve and re-establishment of long-term investor trust.* The current rescue operations via the EFSF are highly distortive since they subordinate later maturing long-term bonds to both short-term bonds and long-term bonds near their maturity date. Such implicit subordination gets worse as more debt is amortised in full by the EFSF, implying – for

budget constraint reasons – a declining likelihood that future amortisations will be similarly made in full. This dynamics has already substantially contributed to the secondary-market widening seen during the current crisis, and worsened the crisis. Time subordination is also extremely dangerous, as it provides governments with incentives to shorten funding maturities going forward. Since junior bonds would be created over the entire yield curve on the rescue event day, there is no such risk under this partial insurance proposal. It brings back the priority of the legal rank principle ('waterfall') over the arbitrary de-facto ranking on the time scale ('first come first serve'). This should help re-establish investor trust.

- *Market control.* The crisis has taught us that it is very important to differentiate the liability side of any large borrower to improve risk monitoring incentives and enable efficient burden-sharing. The proposed structure is just one instrument; others – such as contingent convertibles in the case of banks – are being discussed and partly already implemented. While a junior-senior split is the appropriate instrument for sovereigns, it can also be applied to banks. However, in the case of sovereign finance with fewer control options over balance sheets than in corporate finance, it would be crucial not to split senior and junior debt already upon their creation to keep risk monitoring incentives (or the desire to hedge in markets that will arise as a result of the structure) of senior bond-holders alive.
- *Improvement of communication with the markets.* The markets are highly sensitive to attempts at political manipulation. In contrast to the blue/red bond proposal, where the blue bond GDP limit would immediately come under fire when debt levels rise, under contractually determined partial insurance coverage, political determinations and designations would not come into play before the rescue event date, and even then would be limited to junior bonds.
- *Fiscal cost.* While initially a eurozone partial insurance scheme run by the ESM would need sizeable financial backstopping from higher-rated sovereigns, the accumulation of cash reserves via charging insurance premiums

would reduce this need over time. The EFSF already builds reserves in this way.<sup>6</sup> The required reserves on an expected loss basis of a partial bond insurance scheme will depend on specific insurance conditions (coverage and premia), the probability of and loss-given default, and the sequencing adopted when phasing in the new bond market regime. We turn to some of these issues below; calibration requires a more detailed feasibility assessment.

### Partial bond insurance as a step-by-step formalisation of existing crisis response policies

Bond insurance mechanisms in general and the construct of junior bonds in particular are neither rocket science nor new. They have been used extensively in corporate and sovereign restructurings, including in the Argentine case. Latin American Brady Bonds created a version of tradeable debt in the secondary market after restructuring akin to the tradeable junior bond proposed here.

The constitution of the EFSF as a primary market lender of last resort is already one partial insurance model.

The EFSF has so far been operated under great ambiguity regarding its financial conditions, with key conditions such as the degree of private sector participation, the level of interest rates and terms charged for fresh money being left unspecified until sufficient political pressure mounted. This situation is highly unsatisfactory, and as we advance towards defining the rules of the ESM, which substitutes the EFSF from 2013 onwards, a more systematic solution is required.

However, we already have two political agreements in the eurozone, which could form the basis for that solution: first, a minimum level of protection for existing bondholders, i.e. no

<sup>6</sup> The large German sovereign bond investor Allianz (2011) has proposed to explicitly convert the EFSF into a European Sovereign Bond Insurance Mechanism. However, Allianz proposes de facto full insurance wraps along the lines of US monolines, with a deductible of 10% that would lead most insured bonds into AA territory. This would then be closer to the blue bond, giving rise to the same volume limitation debate as the unconstrained catastrophic risk protection proposed here.

Lehman event in the range of 10% (10c/€) recovery ratio, in a large, systemically relevant debtor. Second, we have nevertheless agreed on substantial private sector (investor) participation. The initiative taken by the Fédération Bancaire Française in June 2011, for example, comes out on Greek existing debt at roughly 50% coverage (50c/€ minimum payout) – the equivalent of the proposed senior bond.

The French banking industry initiative also highlights the options for the ESM to adopt different bond insurance payout variants: 30c/€ will be paid to participating lenders in cash, while approximately 20c/€ will be paid via highly rated zero coupon bonds. It was promptly followed by proportional additional write-downs across the European banking industry on Greek debt in July and August 2011.

The crucial point is the precedent of the acceptance of a specific EFSF coverage ratio by a large investor class, namely banks. The step still to be taken from here to a systematic partial bond insurance model is to further specify and then either statutorily or contractually formalise that ratio.

### **Responding to speculative attacks against a specific ESM partial insurance coverage ratio: Time variation of coverage or a structured defence system?**

George Soros, in his FT comment of 14 August 2011, raised the point about the need for a rather high insurance coverage level by the eurozone initially, to instil market confidence amidst heightened investor anxiety.

While little can be said against the tactical argument, there are also strong arguments from a structural perspective in favour of a more limited coverage, including the imperative to not compromise what the industry already has agreed upon, after a year of painful discussion, to shoulder as private-sector participation for Greece.

A related question is whether there should be a time-constant or time-variable insurance coverage ratio, the first being de-facto a statutory figure, the latter contractual: using a constant figure matching long-term needs of the entire eurozone would have the great advantage of almost eliminating political risk, while a variable figure

could be fine-tuned to the market situation. A constant figure would clearly require special protection in the ESM statutes.

Clearly, the higher and more flexible the partial insurance coverage ratio, the greater the protection of weaker eurozone members will be against speculative attacks. However, also the higher and more flexible the partial insurance ratio, the greater the moral hazard and downgrade risk for the ESM.

Partial insurance even at a constant ratio already goes a long way towards improving shock resilience even for weaker eurozone members, as the simulation shows. The developing defence system against speculative attacks should help to add the needed flexibility. To use a football analogy (pricing indications refer to fixed-rate bullet bonds with maturity of 10 years): the goal keeper stands where the secondary market playing field is limited, e.g. at 60c/€ as in the simulation. This is the ESM as lender of last resort in the primary bond market and partial bond insurer, as described. Defence line: the ESM and the ECB would both remain secondary bond market purchasers, playing at varying bond price levels, but not very far advanced. The danger of intervening early (as the ECB did in the Greek case at 80-90c/€) is to accumulate losses quickly and increase political resistance against an intervention mandate, while being ultimately unable to fend off the speculative attack. As for the defensive mid-field: we need fundamentally changed incentives for institutions to induce them to invest anti-cyclically, e.g. as borrower succumbs to fiscal adjustment programme. Currently, many institutions in the eurozone decide, and in some cases are even told by their regulators, to disinvest from periphery debt, rather than anti-cyclically invest when bond prices have dropped. This is despite substantial general regulatory privileges when investing in sovereign bonds and their implicit backing by governments. The breakdown of the mid-field unduly increases pressure on the defence – the ESM and ECB to gain in scale (investment volumes) and strength (rating). In the offensive mid-field: banks, which hold bonds for both investment and speculation purposes, appear hobbled by undercapitalisation and the regulatory attack against proprietary trading. A number of questions, ranging from accounting to capital requirements, need to be resolved to bring



them back into the market. However, it is noteworthy that in Europe many banks have a rather institutional investor character as long-term investors in sovereign bonds, and a revision of incentives to invest here should have a similar defensive impact, as in the case of institutions.

## Phasing-in

Should only new bonds be enrolled in the partial eurozone bond insurance scheme or both existing and new bonds?

*In favour of new bonds:* In the absence of a clear and in particular credible ranking (see above), the insurance mechanism could be focused on attracting and giving preference to fresh money in a crisis situation. This would reduce the burden on the ESM on the primary lending side, while splitting the primary and secondary market and increasing the probability of secondary market sell-offs.

*In favour of both existing and new bonds:* Enrolling all bonds from day one would immediately stabilise intermediary balance sheets. However, it is potentially more costly and could create adverse incentives. The better route could be the direct stabilisation of balance sheets (e.g. bank recapitalisation).

The call to be made here depends greatly on the scale of the feedback effects between primary and secondary markets. Given that the thrust of the partial bond insurance proposal is to truly attack a large problem (dwindling confidence in the eurozone), to minimise pricing distortions between primary and secondary market segments, and to formalise decisions already made on existing bond portfolios (private sector participation in the Greek case), a comprehensive solution is preferable, i.e. the enrolment of existing and new bonds. This has substantial implications for the size of the EFSF, however, and later on for the ESM. To establish credibility, it will be more important to mobilise the entire defence system described above.

## A number of open questions

There are certainly numerous open questions with a partial bond insurance regime, in particular if it is integrated into a staggered defence structure, as described.

- *Adverse selection/scope:* Should governments that would, temporarily or permanently, not benefit from partial eurozone bond insurance be forced to enrol their bonds? Should bond market sectors that are government-sponsored be enrolled or only implicitly backed? Clearly, the broader the scope, the lower the probability that isolated bond market crises will turn into a general crisis of confidence. Yet, the broader the scope, the higher the explicit capital needs of the insurance.
- *Pricing:* On what historical database and from what time onwards should catastrophic risk protection as described be priced for the individual sovereign? Catastrophic risk pricing would implicitly set a floor under interest rates when the most immediate need is setting a cap. This begs the question of the timing of its introduction.
- *Intervention rights:* When fiscal adjustment needs to start prior to ESM primary market application (e.g. in the case of buying Italian or Spanish debt), the question of automatic triggers for adjustment arises.
- *Seniority of primary market funds:* Even though public claims must not be senior to private claims per se (as numerous historical examples show, e.g. the German financial crisis of 1929-30, in which foreign public claims were senior), the seniority of fresh financial commitments over existing debt must be observed – regardless of the identity of the investor. The eurozone made a contrary predisposition in June 2011: ESM funds rank *pari passu* with existing investors, and below new private investors. This can only weaken ESM intervention capacity and should be repealed.
- *ESM size and protection:* To the extent that the mid-field in the defence system of a partial insurance scheme – banks and institutions – remains non-operational, even in cases deemed to suffer primarily from illiquidity rather than from serious insolvency risk, the ECB and the ESM in particular must have greater room for purchases. This might call for automatic capitalisation mechanisms beyond insurance premia collected and sponsor guarantees given (such as potentially ring-fencing EU-wide VAT revenue to mobilise

capital for the ESM), possibly also for bank rather than agency charter (allowing for repo operations).<sup>7</sup>

## Conclusion

There have been many attempts to solve the eurozone crisis, most of which have failed miserably. The discussants of the existing regime and the Bruegel plan are aware of all the options and their drawbacks.

None of the options in bond instrument design – neither the blue/red bond proposal nor the partial insurance proposal – offers a miracle solution: once over-indebtedness is a fact, some investors are going to take a loss. Once financial crisis has reached the systemic risk stage, stronger governments are needed to support weaker ones, and bold institutional and instrument design steps need to be taken.

However, a partial bond insurance scheme such as the one proposed here, in particular if combined with a structured defence system against speculative attacks, can help to improve communications between the market and government via a proven, credible and transparent concept; minimise market distortions by treating all bondholders equally; contain supra-national protection costs; operate anti-cyclically rather than pro-cyclically; give the investor greater freedom to operate both ex-ante and ex-post, and keep the real causes of market volatility better tied to the credit fundamentals.

## Sources

- Allianz SE (2011), *European Sovereign Insurance Mechanism (ESIM)*, Economic research and corporate development department, 23 March.
- Delpla, Jacques and Jakob von Weizsäcker (2010), “The Blue Bond Proposal”, Bruegel Policy Brief, Bruegel, Brussels, May (<http://www.bruegel.org/download/parent/403-the-blue-bond-proposal/file/885-the-blue-bond-proposal-english/>).
- Fédération Bancaire Française (2011), “Long-term investor initiative for Greece”, Memorandum sent to the Ministère de l’Economie, des Finances et de l’Industrie of France, 24 June.
- Gros, Daniel and Thomas Mayer (2011), “What to do when the euro crisis reaches the core?”, CEPS Commentary, CEPS, Brussels, August (<http://www.ceps.eu/book/august-2011-what-do-when-euro-crisis-reaches-core>).
- Rogoff, Kenneth and Carmen Reinhardt (2009), *This Time is Different*, Princeton, NJ: Princeton University Press.
- Soros, George (2011), “Three Steps to Resolving the Eurozone Crisis”, *Financial Times*, Opinion, 14 August (<http://www.ft.com/intl/cms/s/0/ba30bc32-c4f7-11e0-ba51-00144feabdc0.html#axzz1V4dxdBUn>).

<sup>7</sup> See Mayer & Gros (2011).



## ABOUT CEPS

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is widely recognised as the most experienced and authoritative think tank operating in the European Union today. CEPS acts as a leading forum for debate on EU affairs, distinguished by its strong in-house research capacity, complemented by an extensive network of partner institutes throughout the world.

### Goals

- Carry out state-of-the-art policy research leading to innovative solutions to the challenges facing Europe today,
- Maintain the highest standards of academic excellence and unqualified independence
- Act as a forum for discussion among all stakeholders in the European policy process, and
- Provide a regular flow of authoritative publications offering policy analysis and recommendations,

### Assets

- Multidisciplinary, multinational & multicultural research team of knowledgeable analysts,
- Participation in several research networks, comprising other highly reputable research institutes from throughout Europe, to complement and consolidate CEPS' research expertise and to extend its outreach,
- An extensive membership base of some 132 Corporate Members and 118 Institutional Members, which provide expertise and practical experience and act as a sounding board for the feasibility of CEPS policy proposals.

## Programme Structure

### **In-house Research Programmes**

Economic and Social Welfare Policies  
Financial Institutions and Markets  
Energy and Climate Change  
EU Foreign, Security and Neighbourhood Policy  
Justice and Home Affairs  
Politics and Institutions  
Regulatory Affairs  
Agricultural and Rural Policy

### **Independent Research Institutes managed by CEPS**

European Capital Markets Institute (ECMI)  
European Credit Research Institute (ECRI)

### **Research Networks organised by CEPS**

European Climate Platform (ECP)  
European Network for Better Regulation (ENBR)  
European Network of Economic Policy  
Research Institutes (ENEPRI)  
European Policy Institutes Network (EPIN)