SBBS: Low risk without mutualisation?

Diario Expansión (Spain)
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04 Jun 2018

Last week the European Commission presented a proposal for developing a new class of low-risk assets denominated in euros. SBBS, or sovereign bond-backed securities, are securitisations backed by a set of sovereign bonds of euro zone countries. Each SBBS would thus incorporate an exposure to a small part of sovereign bonds of each euro zone Member State.

The initiative to develop a low-risk asset denominated in euros is not new, and has been on the table for quite some time. The European authorities are conscious of the fact that in the EU as a whole it is not possible to operate with a national (mainly German) sovereign bond as a low-risk asset in euros.

However, practically all the options analysed so far have run into the same sticking point, that of the mutualisation of risks among different Member States, the great divide between Northern and Southern European countries. Precisely the main attraction of these new assets lies in the fact that they do not require risks to be shared among the various States. In theory the reason why they could be classed as low-risk is the diversification of sovereign bonds backing them and the fact that the issuance would be structured in a number of tranches, thus dividing the credit risk (the Commission envisages 70% of the issuance consisting of a senior tranche, which would be the last to assume potential losses).

This proposal, which falls far short of eurobonds, aims to unblock the path with a view to the European Summit in June and to seek a consensus point between the different positions. However, even though the pitfall of mutualisation has been avoided, there have been no signs of this proposal's being given a warm welcome by any State. In the North of Europe the fear is that this process may end in mutualisation "through the back door", if for example the issuer of the SBBS were public, which seems out of the question for now. On the other hand, national Treasuries are worried about how the introduction of these new assets could affect liquidity in their public debt markets.

SBBS may be a viable option for continuing to move ahead with the European project, since they present many advantages. On the one hand the base of low-risk assets in euros would increase, at a time when demand for them is increasing and supply is limited. Furthermore, these assets may help mitigate the problems of financial fragmentation that still exist in the EU, since they would bring national sovereign bonds to a broader base of investors to which they perhaps did not all have access previously. They may also encourage diversification in portfolios of sovereign debt in the banks, given that each SBBS would incorporate a small part of public debt of each euro zone State. At the same time, being an instrument issued by the private sector, it could encourage better spreading of risks among private agents, since there is no public financial support in these assets.

However, for this project to succeed, it will have to overcome several challenges. A new asset, which moreover is a securitisation (seen as the main culprits during the crisis), may encounter obstacles to its acceptance by the market. Furthermore, some of the characteristics envisaged by the Commission may make the instrument less attractive. For example, its issue on demand, which may make it difficult to reach a sufficient volume of assets to ensure appropriate functioning of the market.

So far we have seen no particular enthusiasm in the market for these new assets. The main doubts concern the profitability they may offer, the credit rating they would be given and the potential demand for the most subordinated tranches.

At first sight the Commission's proposal does not seem sufficient to drive the issue and development of the market for SBBS, which are still perceived with great uncertainty. But it is far too soon to venture a forecast as to their possible future. Not least because the proposal still has a significant legislative path to tread before we will be able to assess the market's reception of these new instruments.