The European Safe Asset Debate

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Presentation to the Joint Meeting of the AAE Insurance, Pensions and Risk Management Committees, 10 October 2019

Agenda

- Safe assets and their economic and other benefits
- Possible approaches and possible investor perspectives
- Possible AAE engagement?

See associated (draft) paper by Malcolm Kemp, to be discussed by the RMC on 11 October 2019

Background

- Representatives of AAE met with representatives of the European Stability Mechanism on 3 September 2019
  - Including Kalin Anev Janse, Member of Management Board and Secretary General of ESM and EFSF
  - ESM a significant issuer of Euro-denominated sovereign-supported debt
- AAE encouraged by ESM to engage in the European safe asset debate
  - Institutional investors (e.g. pension funds and insurers) key source of purchasers for government / safe debt
  - AAE capable of providing broader public policy input

Inherent appeal of safe assets

- Many financial transactions involve collateralisation and/or maturity transformation
- Facilitated if instruments used are as credit risk-free and as liquid as possible and across as broad a range of terms as possible
  - I.e. **safe assets**, so adequate supply of such assets should offer intrinsic economic benefits
- Or even if little intrinsic benefit, market practitioners ought to like such assets and pay a premium to access them, benefiting (government) borrowing costs etc.
  - Modern version of 'seigniorage'. At a global level reserve currencies tend to exhibit these characteristics

European dimension

- In light of the Eurozone Sovereign Debt Crisis of c. 2010 – 2014, commentators such as Strauch (2018) stress added financial resilience such instruments might bring particularly if combined with other policy measures to mitigate sovereign-bank feedback loop

- But challenges include:
  - EU a set of member states (not all in Eurozone) and different sovereigns ascribed different credit ratings
  - At present, market's view of euro-denominated safe assets coalesces around most creditworthy member states (e.g. Germany), but these are not the largest issuers
  - Are there enough European safe assets? In 2018, c. EUR 1.5 tn of AA+/Aa1 euro area central govt debt (3.2 tn if include AA/Aa2 rated French bonds) versus US$15 tn in US treasuries

Leandro (2019) argues:

Policy Area	Potential benefits
Financial stability	***Bank-sovereign nexus***: ensure sufficient supply of safe assets in Europe, combine diversification with de-risking ***Flights-to-safety***: de-link safe asset from any specific sovereign, preserve monetary policy transmission in crises ***Fear of redenomination***: reduce risk from banking-sector events outside government's control
Economic Growth	***Financing***: appealing investment proposition, allowing smaller member states access to international investors ***Mitigate distortions in financing costs***: de-link financing costs for rest of economy from relevant costs for sovereigns, new European anchor for corporate credit ratings, reduce cost dispersions for similar firms across member states ***Banking Union***: reduce incentives for ring-fencing of liquidity, make geographically diversified banks better able to absorb shocks, more homogeneous access and transmission of monetary policy ***Capital Markets Union (CMU)***: create a genuine euro area yield curve and pricing reference, based on common savings (banking) market
Financial sovereignty	***Anchor international role of euro***: provide safe store of value, reinforce governance and credibility of EMU architecture ***Complement Banking Union and CMU***: greater capability to exploit economies of scale and deliver investment needed for innovation, more competitive and resilient globally

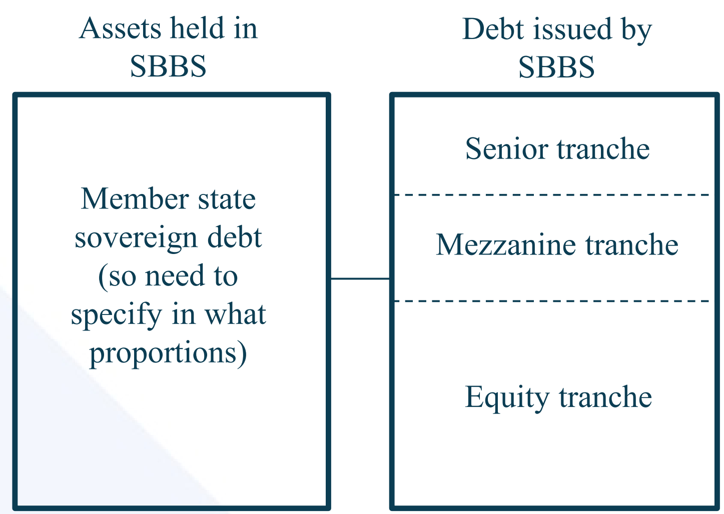
Source: adapted from Leandro (2019)

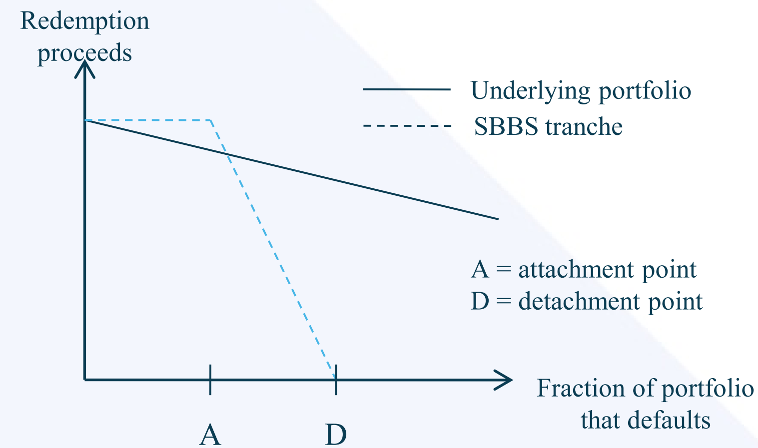
European dimension (2)

- Addressing the potential shortage, if there is one, faces challenges:
  - Specific issuance by a central EU body currently seems to be a political step too far
  - Merely combining different sovereigns’ debt into (non-tranched) pools doesn’t alter underlying economics. E.g. still risk of flight to quality in times of crisis
  - A core strand of debate is whether use of tranching might assist, i.e. some claims being senior and others being subordinate
- Most researched tranched solution involves Sovereign Bond Backed Securities (SBBS), previously called ESBies
  - But researchers have also proposed other approaches

Sovereign Bond Back Securities (SBBS)

- Tranche concept is same as for Collateralised Debt Obligations
- Added complexity regarding incentives applying to junior tranche
  - Lack of commonality of interest with holders of other tranches; junior tranche holders may worry that a sovereign default might be structured to penalise them the most
- Investors may demand a yield premium to compensate for incentive misalignment and the extra complexity, legal risks etc. involved





Source: adapted from Kemp (2017). *Systemic Risk: A Practitioner's Guide to Measurement, Management and Analysis* actuarial association of europe

Proposed approaches include

		Order of seniority and diversification	
		Seniority first, then diversification	**Diversification first, then seniority**
Seniority	**… at the level of the debt instrument**	***National tranching***: Safe assets as senior tranche of national sovereign debt. Subsequently, diversification of senior tranches on bank balance sheets	***SBBS***: Safe assets as a senior security backed by a diversified portfolio of sovereign debt bought at market prices
	… at the level of the issuer	***E-bonds***: issued by a senior intermediary that buys national sovereign bonds at face value and passes on funding costs ***Debt issued by a euro area budget authority***	

Source: adapted from Leandro and Zettelmeyer (2019)

Some comments on the four approaches

- ***SBBS***: Most researched, but depends on certain regulatory changes and on enough investors being willing to buy the junior tranches. How would incentives appear to investors?

- ***E-bonds***: To some extent already exist, e.g. ESM, given its implicit priority creditor status, but would this status remain robust in permanent non-crisis context?

- ***National tranching***: in theory just another way of financing government debt, but in practice also sensitive to investor sentiment on incentive misalignment and might fragment liquidity?

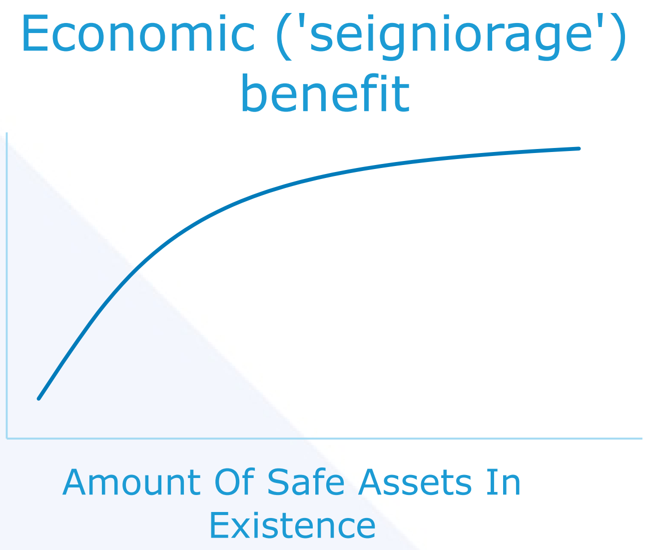
- ***Debt issued by euro area budget authority (or Sovereign wealth fund)***: potentially politically challenging?

Quantifying the economic benefits

- Most derivatives and securities lending transactions collateralised by cash. Already have central safe asset issuer, i.e. ECB alongside relevant member state central banks

- For longer durations, likely tapering of marginal benefit as amount issued rises
  - C.f. If liquidity key element then Estes (2016) noted that c. 68% of total daily volume in US treasuries was then accounted for by the less than 2% of total stock formed by the then 6 on-the-run Treasury bonds

- Difficult to quantify the benefits arising from contribution to more political agendas (e.g. Banking Union and Capital Markets Union)



Questions for IC, PC, RMC to explore?

- **Is this a topic of interest to the Committees?**
  - Insurers and pension funds major investors, hence success of such initiatives likely to be influenced by their attitudes
  - Multiple risk dimensions could benefit from an actuarial perspective
  - AAE Board keen for AAE to contribute to well-being of society and concern for the public interest
- **If so, how might we best engage in this area?**
  - Suggestions welcome!

The Role of Actuaries

Employing qualified actuaries greatly strengthens a financial institution's risk and capital management, resulting in increased security of policyholders, shareholders and beneficiaries, to the benefit of the institution and its stakeholders. Furthermore, appropriate involvement of qualified actuaries can help supervisors to enhance the effectiveness of the regulatory process.

Actuaries …

… fulfil many roles in a broad range of environments, including insurance, pensions, regulation, and other fields.

… have a detailed understanding of economic, financial, demographic and insurance risks and expertise in

- developing and using statistical and financial models including modern methods in data science
- informing financial decisions and solving complex financial problems
- pricing, reserving, and setting capital requirements for uncertain future events.

… also provide advice on the implementation of an effective and efficient enterprise risk management, including reinsurance arrangements, investment policies, capital levels and stress testing.

Actuaries deal with risk.

Deep understanding of mathematics, statistics, data science and business management clearly is a strength of the actuarial profession. Furthermore, actuaries are experienced in dealing with uncertainty, including the analysis of future events.

Financial regulation nowadays is principle based.

Risk functions and risk management roles in financial service firms have grown in importance in recent years, due in part to regulatory requirements such as Solvency II. In an effective risk governance, risk managers need to be an integrated part of the business decision process.

New risks need to be managed and opportunities to be understood.

Traditionally, the risk management was seen just as a control function. Now it becomes more and more important that the management follows a balanced approach of understanding both risks and opportunities. Actuaries play an important role in enabling the management to draw informed decisions acknowledging both aspects.

Competences and skills secure leading risk management.

The cornerstones of the actuarial skill set are a thorough education, continuing professional development, and adherence to ethical and professional standards. Professionalism in the form of strong values as accountability, objectivity and integrity is part of their DNA.

Actuaries enrich the Risk Management due to …

- **strong analytical skills** including experience in new methods in modern data science and handling huge data sets
- the **ability to distil complex topics and issues** into relatable and simpler term
- hence being **good communicators of complicated topics** across the both sides of the balance sheet
- their **critical thinking** and ability to challenge all aspects of the business model
- however, also being **business minded and solution oriented**
- reliance on **professional code** ensures thoughtful risk managers

Together with other professions actuaries form an integral part of a divers, heterogenic group of people to jointly assess relevant risks and provide effective mitigation strategies.

Comprehensive Education and Professionalism.

Different competencies and skills are required to secure for actuaries a leading risk management position in a rapidly changing world of society and work. Professionalism and an outstanding training (e.g. CERA) are inevitable assets and provide stakeholders of actuaries with strengths to rely on:

- Deep understanding of mathematics, statistics, data science and business management ensured by a comprehensive syllabus.
- Experience in dealing with uncertainties and risks by a minimal amount of years of practice
- Professionalism and continuous development

Strong worldwide network.

The strong network of actuaries worldwide gives a great advantage relative to other professions, as it provides for example clear and high professional standards and a wide basis for retrieving information and organizing research and training.
Specifically in Europe well organized local actuarial associations under the umbrella of the AAE (Actuarial Association of Europe) maintain high standards and contacts between markets and regulators.

[1] Certified Enterprise Risk Actuary is a world-wide standardized and accepted trainings program for actuaries in Risk Management

Summary

- **Safe assets and their economic and other benefits**
  - Policymakers are interested, for a variety of reasons
  - Pure economic benefits of additional issuance not easy to quantify
- **Possible approaches and possible investor perspectives**
  - All seem likely to face challenges
- **Possible AAE engagement?**
  - Looking for your input and suggestions!