STATEMENT

PUBLIC CONSULTATION OF THE EUROPEAN COMMISSION AND THE EUROPEAN PARLIAMENT ON THE REGULATION OF SOVEREIGN BOND-BACKED SECURITIES

A. Background of the Regulation Adjustment

The high interdependence between states and home-based banks is widely seen as the major reason for the intensity of the Euro crisis of 2010 until 2012. The Reflection Paper on the Deepening of the Economic and Monetary Union of the European Commission from May 2017 contains different proposals to break the so-called sovereign-banking nexus, particularly concerning the completion of the Banking and Capital Markets Union. Furthermore, the development of Sovereign Bond-Backed Securities (SBBS) was taken into consideration and the European Commission presented a proposal in May 2018.

SBBS are a portfolio which contains bundled government bonds of the 19 Eurozone-countries and which is placed as a securitized financial product on the capital markets. The share of government bonds of each member state on the total portfolio depends on the equity share of the respective country at the European Central Bank (ECB). Moreover, only a certain percentage of issued government bonds of a country can be bundled in the new instrument. The bundle should consist of 70 percent of European safe bonds (ESBies) und 30 percent junior bonds (EJBies). These tranches are remunerated differently in the event of loss. That means concretely that claims from the junior tranche are subordinated and securities of the senior tranche would only be considered if the junior tranche is completely written off. Depending on their willingness investors can decide between tranches with higher or lower risks and will realize a corresponding return on the security paper. Emission and administration of these instruments should be managed by a commercial institution that bears the liability risk in case of losses together with the private investors. Thereby, joint liability on risks and losses within the European Monetary Union should be avoided.

The Commission proposes the following regulatory adjustments:
- Introduction of a definition of SBBS that lists all properties which need to be fulfilled so that a securitization of Euro area government bonds from the private sector is considered as SBBS
- Regulatory equal treatment of SBBS and government bonds regarding equity requirements, eligibility as collateral for the Euro system and as security

The Commission expects the following advantages:
- Stronger diversification of the banks' portfolio on government bonds to break the sovereign-banking nexus and minimizing risks in the banking sector
- Creation of a new safe asset and thereby increasing the liquidity on the European capital market
- Contribution to the completion of the Banking Union and to the development of the Capital Markets Union through deeper integration and diversification on the government bonds market

status: July 2018

B. Assessment of the German and European Mittelstand

The German Association for Small and Medium-sized Businesses (BVMW) and European Entrepreneurs (CEA-PME) oppose a regulatory adjustment of SBBS for the following reasons:

The Commission assures that the proposed instrument of SBBS will preclude **harmonization of debt** among the Euro area countries. However, these products seem to be the first step towards collective debt liability. The BVMW is clearly against introducing Eurobonds through the back door.
The German and European Mittelstand appreciates the European Commission's commitment to reform. The economic integration of Europe over the last 70 years is a success-story, which can only be continued if the overall structure of the EU is on solid footing again. Therefore, comprehensive reforms are necessary. But the **principle of debt and liability** needs to have a stricter focus. Incentives to accumulate debt at the expense of other countries need to be avoided.

The German Bundesbank has long been calling for a **cancellation of the regulatory privileged treatment of government bonds**. Banks and other financial market participants hold the majority of outstanding government bonds in their books as those are considered to be safe and do not need any equity backing. As soon as banks are demanding less government bonds, the yields will go up and the respective countries face financing difficulties. That in turn will put a burden on the banks and the downward spiral will be set in motion. The Bundesbank proposal aims to break this cycle. The Mittelstand supports this recommendation. An equal treatment of government bonds and securitized financial instruments such as SBBS would fundamentally contradict that goal. That is even more the case considering that the risks will not only disappear by bundling them – something that became clear during the worldwide financial crisis of 2009. At that time junk loans on the US-American real estate market were bundled into structured products and resold as being safe. The bubble burst when more and more homeowners defaulted on their loans. Hence, the Commission's proposal would deregulate a financial product that was **one of the triggers of the crisis in 2009**.

Experts show that an **AAA rating** for SBBS seems **unlikely**. The probability of default of government bonds are highly correlated. Thus, in case of a crisis not only one country would face the risk of default. Therefore, the supply of safe assets in the Euro area could become even smaller instead of larger. Issuing such structured financial products is already possible under the current regulations. The lack of supply shows that financial market participants do not demand such a product due to the higher risks.

The **allocation based on the ECB's capital key** will lead to a situation where the relative share of stable bonds of smaller euro area countries will be infinitesimal. Thus, those bonds cannot equalize the default of a larger member state.

It is likely that debt securities of highly indebted member countries, which are bundled in SBBS, will have lower **interest rates** than regular bonds of these countries. Accordingly, the remaining outstanding securities would show higher interest rates, as their risk rises and demand should generally be lower.

The presented proposal and the hectic schedule for approval are only due to the **European elections** in 2019. Critique and concerns of experts should be taken seriously during the consultation phase. At this far-reaching step of European integration accuracy is much more important than rapidity.

Including its alliance with other SME associations (Mittelstandsallianz) BVMW represents over 600.000 small and medium-sized enterprises from all industries and regions with more than 11 million employees. The more than 300 local BVMW representatives service more than 700,000 direct business contracts per year. The BVMW organizes more than 2,000 events each year. Our European umbrella organization European Entrepreneurs (CEA-PME) represents the interests of 32 member associations with more than 2 million companies and 25 million employees.

Contact CEA-PME:
European Entrepreneurs (CEA-PME) | CEA-PME Office
Avenue de la Renaissance 1, B-1000 Brüssel
T +32 2 7396264
stefan.moritz@cea-pme.com, www.cea-pme.com

Contact BVMW:
German Association for Small and
Medium-Sized Businesses (BVMW e.V.)
BVMW Head Office, Politics and Economics
Potsdamer Straße 7, 10785 Berlin
T +49 30 533206-0, F +49 30 533206-50
politik@bvmw.de, www.bvmw.de