

The EU leaders appear to be considering the use of leverage to boost the amount of funds at the EFSF's disposal. Inasmuch as excessive leverage was one of the primary causes of the recent crisis, news reports have been critical of public authorities' use of leverage. But in this case the use of leverage—or of a funding structure tailored to the risks involved—is necessary, and it may be used in a broader range of applications and not just in response to the European crisis. Further, while the supply of funds may sometimes be essential in response to a crisis, it has the side effect of impairing financial functions by making it more difficult to select funding tailored to risks. The following report, titled "Towards a Restoration of The Logic of Equity," is a translation of my article for a book published early this year. While I was overly optimistic on developments in the financial system and monetary policy, I cannot help but feel the problems themselves have changed little since the beginning of the year.

Government credit support tailored to risk profiles

The problems in Europe surfaced in 2009 when Greece revealed it had cooked its fiscal books. Over a year later they are still with us, with no end in sight. Governments in the problem countries have announced fiscal consolidation policies, but market concerns continue to deepen.

There were hopes that the EFSM, formed last May under an agreement between the EU, national governments, and the IMF, would succeed in stabilizing the markets with its €750bn in funds, enough to fund the problem countries' debt rollovers for the next two years, but now market participants are increasingly concerned that this will not be enough, leading to furious debate over the expansion of the EFSF.

Fiscal deficits are at the core of the problems. Inasmuch as concerns about the spread of fiscal problems to non-"PIIGS" countries is partly responsible for the decline in confidence in the EFSM, a fundamental solution will not be possible unless countries throughout the region can show a convincing plan for achieving longer-term fiscal health.

In addition to the self-evident but difficult-to-implement fiscal response, this problem has aspects of finance. In particular, we should not overlook the risk that simply increasing the size of the EFSF will lead us into a vicious cycle that feeds on market concerns. While some believe there will be no peace until the EFSF has enough funds to cover the total outstanding debt of the problem countries, the "PIIGS" alone had outstanding debt totaling some €2.8trn at the end of 2009, and given the possibility that more countries will join their ranks, it is unrealistic to assume that countries like Germany and France will be able to increase their contributions without limit.

One way around this impasse would be to structure credit support measures to reflect risk profiles.

The EFSF issues bonds guaranteed by the EMU and lends the proceeds to heavy debt nations. These guarantees are meant to cover 100% of the EFSF bond principal. However, the government bonds that are effectively replaced by EFSF bonds in this process would have a greater-than-zero recovery even if the issuing nations were to default. For example, current yields on these nations' debt are pricing in the expectation that even if the debt is restructured the eventual haircut will be less than 100%.

At least from an economic perspective, then, all the EMU members need to do to effectively ensure the return of principal on the EFSF bonds is to provide the EFSF with a guarantee against expected losses (EL) on the loans, which is equivalent to this haircut. This argument holds even if we assume that credit risk related to (1) the redemption of existing government debt issued by the problem countries

and (2) the repayment of loans from the EFSF is the same. And if credit risk on the EFSF loans was slightly lower, since they entail the implementation of economic programs agreed to with the EU and the IMF, expected losses would shrink. Of course provisions must also be made for unexpected losses (UL), but the EMU guarantees issued to the EFSF are in fact over-collateralized relative to the principal of the EFSF bonds, so to some extent this issue has already been dealt with.

The criticism may be made that it would be politically hard for EMU nations to contribute funds based on the premise that they would eventually incur a loss. But this is not wasted money; the EMU countries will be able to keep EL in check through governance over the economic programs. And if the program involves long-term repayments via a restructuring of the problem countries' debt, applying the EMU's loan guarantees for the EFSF could further reduce the possibility of actual losses, although it would take time to recover the funds. The expectation is that the EMU countries will be able to obtain a similar economic effect with a smaller outlay than under the current approach, where loan guarantees are issued for 100% of the principal. This would not only reduce the fiscal burden but significantly enhance their flexibility in the event the ranks of distressed nations were to grow.

The approach of restructuring credit support in line with risk profiles can be applied even more explicitly to the ongoing debate over GSE reforms in the US.

Fannie Mae and Freddie Mac ran into problems when a sharp decline in US housing prices impaired the quality of their mortgage guarantees and were nationalized in the autumn of 2008. Conditions subsequently worsened as government measures to prop up the housing market led to a relaxation of credit standards, and today both entities continue to receive taxpayer money under a framework established by the US government. Although the Dodd-Frank legislation requires the US Treasury to submit to Congress a plan for reforming the two institutions, it will be difficult to carry out reforms while maintaining the GSEs' functions to the extent that the housing market remains a drag on the recovery and foreign investors hold some \$800bn in mortgage-backed securities (MBS).

At the heart of the problems is the question of how to support the MBS guarantees issued by the GSEs. Although Treasury Secretary Geithner has declared repeatedly that the US government will guarantee all the GSEs' liabilities, no money has been allocated for this purpose, and it is not a realistic option for a US government already burdened by a massive fiscal deficit to take on \$6trn in additional obligations.

But in the case of the GSE reforms, there is the option of using taxpayer money to recapitalize these institutions. Injecting capital in drips and drabs to prevent a technical bankruptcy—the approach followed thus far—will not lead to

a resolution of the problems. However, one alternative would be to estimate the expected and unexpected losses on the GSEs' MBS guarantees based on forecasts of housing prices, make appropriate provisions for the expected losses, and inject government money to keep capital levels high enough to absorb the unexpected losses. According to estimates published last September by the CBO, the GSEs would require a capital injection of about \$400bn under a housing price stress scenario. While that is not a small amount by any means, it suggests the possibility of achieving an equivalent economic impact with far less taxpayer money than would be required using a 100% principal guarantee.

Structuring fiscal funding in line with risk profiles

The above discussion of Europe's EFSF and the US GSEs focused on restructuring existing public credit support schemes in line with risk profiles. But the approach can also be applied to fiscal funding itself.

National and regional governments issue bonds to pay for expenditures that cannot be covered with tax revenues. In most cases these are general revenue bonds that are not linked to specific expenditures. An alternative approach might be to divide funding sources according to the characteristics of the government project or policy.

Naturally, some projects and policies do not have any direct revenues and are effectively a transfer of income, and those should be funded with tax revenues or other general revenue sources. It is not healthy to begin with for a large number of projects and policies to be funded with outside money.

But there are some projects, including so-called social capital, that will serve as specific revenue sources. Accordingly, one alternative to funding all expenditures with government bonds would be to restructure funding methods for identifiable projects such that they are tailored to specific risk profiles—e.g., funds with particularly long redemption periods, funds that will allow investors to receive some of the operating income from the project, and funds that will be subordinated to other government bonds, in something similar to the equity tranches of securitized products.

This kind of approach could help stabilize unstable risk premia inasmuch as sovereign risk is assessed based on difficult-to-quantify factors such as the ability of governments to collect taxes and the stability of demand for government bonds. And by making the project being funded subject to market governance as well as oversight from the general public, it could also lower the cost of funding compared with centralized funding. Further, in the event of a fiscal crisis, such an approach could prevent a significant impairment of government functions and enable the public sector to carry on projects required for private-sector economic activity.

Central banks role in maintaining market functions

Structuring funding tailored to risk profiles, as discussed in this report, is of course a basic principle of the securitization process. And the concept of using capital to meet UL underpins the various capital adequacy ratios established by the BCBS.

Meanwhile, it is interesting that this approach, which is standard in the financial world, has seldom been discussed in the content of public debt. Both the authorities and market participants have fresh memories of the crisis, and the various problems that emerged in the US market for securitized products could make it politically difficult to argue vocally for the restructuring of funding in line with risk

profiles—particularly at a time of tougher regulation of such products, including higher capital charges.

However, it is clear that the problems in the securitization market were not attributable to this approach per se but rather to dysfunction in various key aspects of the market, including disclosure and investor behavior, governance over securitization vehicles, originator incentives, risk assessment of underlying assets, and the authorities' understanding and supervision. Ignoring these differences and abandoning the underlying principles of securitization themselves would be a case of throwing out the baby with the bathwater and would mean the loss of the kinds of benefits described above.

If, on the other hand, the problem is that funding in line with risk profiles makes sense but does not pay in practice, then the situation may be worse than originally thought. In the context of the fiscal problems above, the argument here would be that since ordinary government bonds can be issued at such low cost, there is no need to engage in the costly structuring of funding. Entities in this position include both the developed economies and the EFSF, which is attracting active bids from global investors.

One of the major reason is that central banks in the developed nations are supplying funds in such large quantities. The ECB's massive LTROs, the Fed's "QE2", and the BoJ's asset purchase program all aim, to a greater or lesser extent, to reduce risk premia in the markets. As a result, credit spreads in the money markets and corporate bond markets of the US, Europe, and Japan have tightened (debt issued by Europe's problem countries being the sole exception). Naturally, this policy is significant in the sense that it helps lower effective interest costs for borrowers. But it also complicates the appropriate pricing of risk and makes it more difficult to structure funding in line with risk profiles.

This phenomenon is at the heart of the loss of market functions noted as a side effect of extremely accommodative monetary policy. To be blunt, there will be incentives for the problem countries to continue issuing debt as long as the ECB continues to supply large quantities of funds. A similar fiscal risk awaits the US (e.g. the GSEs) and eventually Japan.

In 2011, I anticipate that debate will focus more on the effects and side effects of central bank policy on credit. Both (1) the need to revitalize private credit markets with an economic recovery and (2) the need for an approach to fiscal problems that is acceptable to all developed nations are likely to lead to a new focus on the use of structured funding tailored to risk profiles—i.e., the use of capital (equity) which, by virtue of its subordination, can serve as a buffer against unexpected losses and ultra-long-term liabilities.

Source

Next-Generation Financial Business Trends: 2011 (Japanese), NRI, 2011, pp. 22–28.

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