European Rates Strategy

QE: NCBs won't really take the risk on their own

Interest Rates

Europe including UK

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NCBs would not ultimately take the loss in a default

While it might be announced that credit risk from QE purchases might lie with the national central bank (NCB), NCBs buying their own bonds would not ultimately take any losses. Instead, these would be borne either by other bondholders or by the rest of the Eurosystem, depending on whether NCBs were senior or not.

Explicit declaration of seniority unlikely

Such a move would risk accelerating market stress were worries to resurface over the solvency of any member state.

But if it came down to it, non-explicit seniority might apply

There are several forms of this, all of which have the same subordination impact. We look at three possible examples.

A broader implication

The euro area may end up with more than one monetary authority conducting more than one monetary policy.

Sovereign debt subordination explained

For those unfamiliar with how it works, we produce a simplified example.

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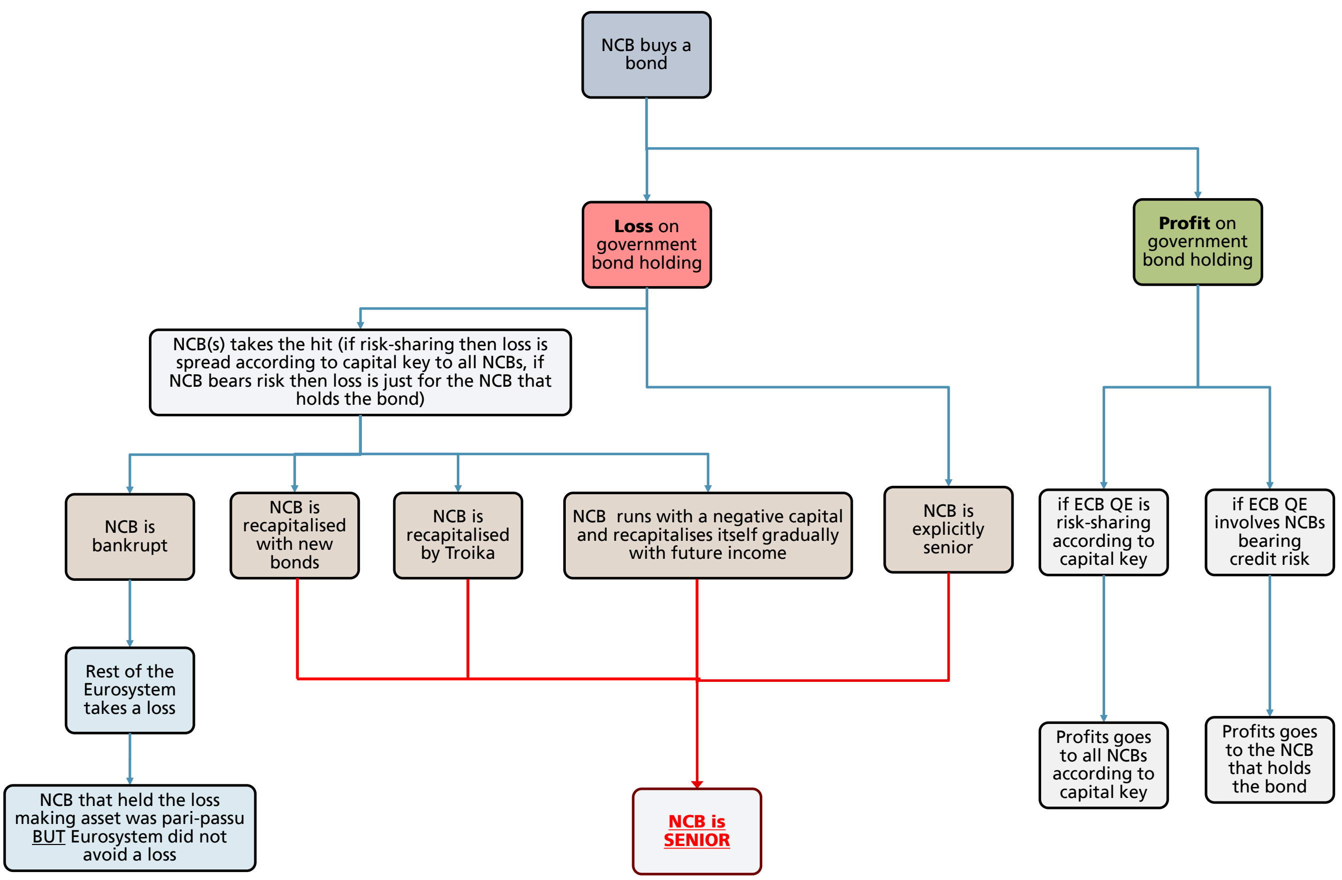
QE: NCBs won't really take the risk on their own

We do not know for sure what will be announced by the ECB, this Thursday or subsequently. But media reports indicate that the ECB is considering conducting a quantitative easing programme in which the credit risk of some of the bonds purchased are assumed by the national central banks (NCBs) individually; instead of jointly as is normal in the conduct of monetary policy in the euro area.

We think it is unlikely though that any NCB – or the government of which it is a part - would ultimately ever take a loss individually from a default as that would be borne either by the rest of the Eurosystem[1] or by the other bondholders. In other words, either the concept of NCBs relieving the rest of the Eurosystem of credit risk would largely be an illusion or bondholders would be subordinated by NCB purchases.

Figure 1: Consequences of profits or losses accruing to NCBs, depending on the decision path of the NCB/Eurosystem



Source: UBS
Note: It is possible that a NCB could have enough capital to absorb some/all of a potential loss on its aggregate bond holdings but in theory excess capital should have already been passed over to the member state. Therefore we have just focused on the implications of a loss on a government bond holding when a NCB holds its optimal level of capital only.

[1] Comprised of the ECB and the NCBs

Explicit subordination of other bondholders is not likely…

The question of which of these is true depends of course on whether the NCB and its government decides it is senior to (i.e. is repaid ahead of) other bondholders. If the ECB does announce a QE programme, then it may not state explicitly whether central banks are senior. If it does, we would expect it to say that NCBs (whether individually or collectively) would be on an equal footing with investors. If, otherwise, the NCBs are *explicitly* senior then the more bonds that it purchased of some peripheral countries, the less other bondholders would want to own them. This could cause a severe acceleration of bond market stress were worries to resurface over the solvency of any member state.

… but "pari passu" passes the risk to the Eurosystem

As we have argued before, were the NCB to assume an equal status to other bondholders, the risk ultimately would lie with the Eurosystem[2]. NCBs would likely only be buying the bonds of their own respective countries as there is no incentive to do otherwise. So in the event of a default in the bonds which they held, they would have to turn to their own governments for recapitalisation.

But of course the government of any NCB in this situation would not be able to help, so the NCB would in effect be bankrupt and the loss would ultimately be passed to the Eurosystem which printed the money to enable the purchases in the first place.

It is very possible that the (hopefully) hypothetical situation of a country in default with its central bank insolvent is also likely to be one of a country on its way out of the euro area. Other things being equal, it seems likely that some *non-explicit* form of central bank seniority would apply in order to avoid that happening.

Non-explicit forms of central bank seniority

In the scenario of a default on the bonds which an NCB holds of its own country, there are many ways in which it could retain senior status, all of which would subordinate other bondholders in the same way. Examples might include:

1. **If an NCB's holding is made good by an aid programme.** If other member states and/or the IMF lent money to a country which included funds (or bonds) destined for the central bank to make it whole after a restructuring, then the debt of that country would increase by that amount, meaning that the debt owed to other bondholders would have to be cut accordingly in order for the issuer to remain solvent.

2. **If an NCB is recapitalised with new bonds issued by its government.** Again, the debt of the issuer would increase and therefore the haircut to other holders increased. This would be similar to the actions which the Eurosystem took in the Greek debt restructuring, except that the bond swap would be taking place just after the event instead of just before it.

3. **If the NCB recapitalises itself gradually with future income.** The profits gained in conducting monetary policy are ultimately handed to the government by its NCB. If instead they are used to cover a loss at the NCB then a portion of government revenue would have to be used to make

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[2] See *Macro-Strategy Key Issue: "ECB preview – Day of reckoning is nigh"*, 19 January 2015

the NCB whole and therefore other bondholders would have to suffer a greater haircut in order for the country to remain solvent.

In each of these examples, the NCB's holding is being made whole out of the future income from its own government, while other bond holders are being made to take a greater loss than they otherwise might. (For those unfamiliar with debt subordination, there is a simplified explanation of it at the end of this note).

The willingness of the Eurosystem to take a loss

In the current format of the European Monetary Union then, an NCB holding its own government's bonds can only be truly on an equal seniority with bondholders in the event of default if other NCBs (and therefore their governments) take the loss.

If this is possible, then QE would not cause significant excess stress in the bond markets if a country were nearing default. Naturally, it would undermine the principle of risk residing at the NCB level, but that would be an issue for policy makers, not for markets.

A broader implication

There is one more point to make about individual risk taking by NCBs: It might lead to more than one monetary policy being conducted by more than one monetary authority in the euro area.

We will have to see what the ECB announces on NCB assumption of credit risk on Thursday, or at some later date, if it indeed announces such a policy. But if it is implemented then in essence some part of the control of monetary policy is being handed over to NCBs and away from the ECB. After all, while agreement might be secured from all NCBs to participate this time around, it cannot be guaranteed in the future and one cannot force another entity to take risk forever – even if it is only nominal in nature as we suggest.

As a result, it is worth considering the possibility that a central bank declines to participate because it does not see the need to. This might have far-reaching consequences, especially if – for any reason – market stress is heightened once more in the euro area.

Sovereign debt subordination: how it works

Consider two simplified scenarios:

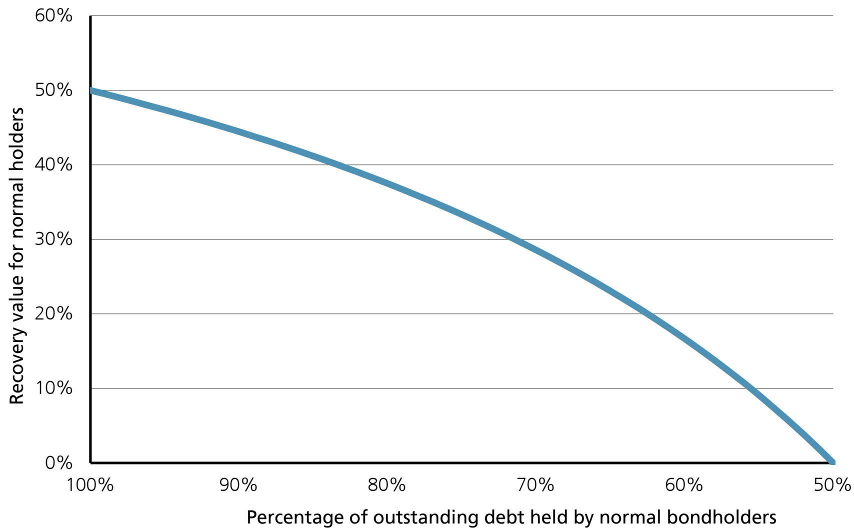
1. The National Bank of Atlantis, a hypothetical euro area NCB, owns €50 of its own government's debt. The small state of Atlantis has issued €200 of debt overall, so the proportion of it held by the NCB is 25%.

   One day, Atlantis gets into trouble over its finances. All observers, including the Atlantean government itself, the European Commission, the ECB and the IMF agree that, given the certain outlook for government finances, the state of Atlantis must reduce its debt to €100, or by 50%, in order to remain solvent. If it is left with €101 of debt then the debt level will keep rising, but €100 of debt is certainly sustainable.

Atlantis duly haircuts its debt by 50% but the NCB needs recapitalising for the €25 loss it has just incurred. In order to achieve this, the Atlantean government either: a) borrows €25 from other member states (or the IMF); b) issues more of its own bonds to give to its NCB or c) agrees to give up future income by €25 to give (back) to its NCB.

In every case, Atlantis increases its debt from €100 to €125. But everyone knows that the maximum debt that it can sustain is €100, so the country must take another €25 from other bondholders - meaning that they only receive €50 of the original €150 they held. In fact, as this sequence of events was already anticipated, it took this step on an ex-ante basis and haircut bondholders by 67% instead.

Figure 2: Recovery value to normal (non-senior) bondholders in the presence of a senior creditor after a 50% reduction in debt, depending on the proportion of debt held



Source: UBS

2. In an alternative ending to the Atlantis restructuring, the government, the NCB and the Eurosystem declare the NCB to be truly equal in seniority to other bondholders. The other euro area member states, either via their NCBs or directly then simply hand over €25 to Atlantis, with no requirement to be repaid - ever. In this way, bondholders take the 50% loss on their holdings that corresponds to the original miscalculation (of the level of Atlantean debt which might be sustainable) which they made when they bought the bonds.

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