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Back to the future with ESM-backed amortising Govvies

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I confess to being a little mystified as to why sentiment picked up around the FinMin meeting since as far as I can make out, there are still far more questions than answers around Spain, Greece, and how the rescue funds will intervene in the market to lower peripheral borrowing costs – although I have a plan for that; see below.

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Credit markets firmly moved into tightening mode into European trading on Tuesday and US stocks were tentatively higher at the US open as participants figured they liked the news out of the EZ ministers of finance meeting, the positive signals from the German Constitutional Court about the creation of the ESM, and continuing evidence of banks shifting cash out of ECB deposits into eurozone government bonds following the Bank's rate actions of last week.

Yet a combination of real-money buying in Spain and short covering in Italy pushed 10-year government bond yields down, respectively, to 6.84% and 5.97% by mid-morning in London and both curves saw some 2-10 steepening.

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Banks and money-market funds also piled into the front end of French and Belgian government bonds.

News about the Spanish bank bailout from the ministers of finance session was at best confused and we still have to wait for the next session before we get the small print. OK, so Spain will get the first €30bn tranche this month from the EFSF, since the ESM doesn't yet exist and the creation of the single bank supervisory agency that will anyway be required before the fund can disburse bailout cash directly to banks will take longer than expected.

It seems to me to be less a question of seeing the light at the end of the tunnel; more a question of let's discuss what kind of tunnel we build and then let's see what happens.

There's still a lack of clarity around the specifics governing the initial EFSF disbursement to Spain as well as figuring out how the EFSF-to-ESM burden transfer will work. We're told that Spain will not be required to provide sovereign guarantees for support to its banks, but what about this interim stop-gap measure where EFSF bailout funds are classified as sovereign debt? What about collateral arrangements? Will EFSF bank bailout disbursements be retroactively transferred to the ESM once this is signed into life? Will that tranche of sovereign indebtedness therefore be neutralised and mutualised? Who knows?

And still we're still getting contradictory signals from various EU officials. Even though the recent leaders summit pronounced that ESM could directly recap banks, there have been mutterings that EZ bank rescue funds would ultimately be considered the responsibility of the respective sovereigns. That undermines moves towards the first steps towards mutualisation of debt that was agreed at the EU leaders' summit.

Mutual respect

BUT HOW ABOUT THIS… an area of applied EZ debt mutualisation: Have the permanent rescue fund finance or backstop sinking funds that hold the cash required to meet the principal payments of new issues of long-term amortising government bonds.

The sovereign would take full responsibility for meeting interest payments, but in the event of a cash shortfall to meet principal repayments, the ESM steps in and makes-whole the sinking fund, subject to structural reform and other conditionalities.

New debt stock of €100bn in an equal mix of 10 and 20-year debt issued over a calendar year would require amortisation payments of just €7.5bn per annum, which the rescue fund could easily fund in the bond market.

Primary debt issuance backed by the ESM would give back bailed-out EZ sovereigns access to capital markets and would cheapen the cost of debt of other embattled sovereigns. It would also reduce the pressure on the rescue mechanism to buy bonds in the secondary market to achieve the same objective.

This idea is taking forward plans already presented by the German Council of Economic Experts with their European Redemption Fund, and by Finpolconsult's Hans-Joachim Duebel who reckons that interest-only debt should be banned and governments forced to issue only amortising bonds.

Investors would have to get used to the idea of average life as opposed to final maturity and would also need to price in call risk, but the securitisation market has lived with these features since inception. Sinkers were a regular feature of the Eurobond market back in the day, while the Dutch government regularly sold sinking fund Dutch State Loans until 1988.

It's certainly less complicated than the European Redemption Fund. If you recall, the scheme proposes that public debt of participating member countries be split into two components: individual governments maintain responsibility for debt up to the 60%-of-GDP ceiling dictated by the Stability and Growth Pact (SGP) and anything in excess of that is spun off into the ERF.

ERF debt would be guaranteed by the Eurozone over its 20-25 year amortisation period (comparable to the 5% annual debt reduction requirements of the SGP for countries with debt above 60% of GDP).

To ensure that redemptions happen in sequence, countries that transfer a greater quantum of debt are burdened with higher annual payment obligations.

Debt mutualisation via the ERF would cheapen debt service costs for heavily indebted countries but it would come with strict conditionality in the form of tax revenues formally earmarked to ERF debt service; a 20% collateral requirement; commitment to structural reforms; an imperative to maintain national debt at or below 60% of GDP through the imposition of debt brakes monitored by outside parties; and maintaining a structural budget deficit below 0.5 % of GDP (as enshrined in the SGP).

Following a ramp-up period the ERF could rise to €2.2trn since EZ government debt to GDP is above 87%. The scheme would force Germany, France, Austria and the Netherlands into economic programmes and subject them to external monitoring agencies that would theoretically have powers to prevent them from borrowing. It's a great scheme on paper but unenforceable in practice.

Finpolconsult's Duebel has long been banging the drum of amortising debt as a solution to the permanent interest-only world governments inhabit. I like his ideas. He sees specific long-term infrastructure projects being financed in the bond market via long-term amortising debt with schedules out to as long as 50 years where necessary. Funds raised through a single bond issue but earmarked for multiple projects could come to market with an average amortisation profile.