Sovereign-bank loop in the EU

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Bank-sovereign loop: how to tackle the nexus

Perceptions of a persisting nexus between banks and sovereigns has not diminished since the European sovereign debt crisis. Even though trends have been different across EU member states, banks' sovereign exposures are still elevated in many countries. In the same context, sovereigns' debt levels and debt sustainability remain a serious concern in an environment of elevated political risk and the future process of monetary policy normalisation.

The European Banking Authority (EBA) regularly releases information on banks' sovereign holdings as part of its yearly Transparency Exercise, thus, contributing to the public scrutiny of these exposures and fostering market discipline. Supervisory reporting data shows that following an upward trend in the years before 2016, EU banks' sovereign exposures have fallen by 10% to a total amount of EUR 3.0tn as of Q2 2018. This corresponds to a reduction of around EUR 400bn in the last two years, with almost half of the decrease relating to domestic sovereign holdings. Comparing sovereign exposures in relation to capital, supervisory reporting data shows that the median ratio of banks' sovereign exposures to Tier 1 (T1) capital was around 170%, with high dispersion across banks and countries (the interquartile range was around 90% to around 260%).

Nearly 50% of sovereign exposures are towards domestic counterparties and foreign sovereign exposures are mostly concentrated in the European Economic Area (EEA) countries. The proportion of domestic sovereign exposures for the largest EU economies (Germany, France, Italy and Spain) ranges between around 50% and 70%, with the exception of the United Kingdom, which is slightly above 20%. The median ratio of domestic sovereign holdings to T1 capital amounted to about 65% (interquartile range around 25% to around 130%).

Sovereign exposures are not risk-free for banks as, for instance, a sudden spread widening can significantly affect banks' profitability and capital ratios. Material spread widening in certain Member States in recent months has highlighted such effects. Exposures measured at fair value are particularly vulnerable. They also constitute the largest share of banks' respective investment: nearly 60% are measured at fair value. Also, the maturity distribution contributes to elevated risks related to banks' sovereign exposures: more than 40% of their holdings have a maturity above 5 years, as such being increasingly vulnerable to spread movements, whereas less than 30% have a maturity of less than one year.

Finally, it should be noted that the EBA also supports the supervisory scrutiny by conducting its stress test exercise biennially. The risks arising from sovereign

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>>> exposures are covered in this exercise depending on their accounting treatment. In particular, the 2018 stress test exercise requested banks to apply the market risk methodology to their sovereign exposures measured at fair value. For sovereign exposures measured at amortised cost, banks had to estimate default and impairment flows applying a set of probabilities of default (PD) and loss given default (LGD) parameters.

As a conclusion, even though with the introduction of the BRRD an important step has been made towards breaking up the bank-sovereign loop, there are still significant risks related to banks' sovereign exposures. Therefore, banks should actively manage related risks and ensure appropriate diversification. From a supervisory perspective, competent authorities need to continuously monitor banks' holdings in sovereign exposures and ensure that respective vulnerabilities are well managed by institutions. Stress testing provides an essential input for supervisory assessments, whereas periodical public disclosures and further transparency enables market scrutiny. This is in particular relevant, given that the prudential framework requires no or limited capital set aside nor sets limits on concentration risk – contrary to other types of exposures held by banks. ●

David Vegara

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Completing the European Banking Union

Building a full Banking Union (BU) is a long-term endeavour. Currently, its architecture still remains incomplete and there is an urgent need to move forward as we should not leave the project half-way.

First of all, banks and sovereigns are interconnected by multiple linkages such as direct holdings of government debt on banks' balance sheets, government guarantees of financial products and assets, public ownership of stakes in banks, and the macroeconomic channel. As these links can be interdependent, public policies need to be of a holistic nature. Furthermore, this nexus can be weakened, but probably not completely reversed. Hence, any future regulatory decisions regarding the prudential treatment of these exposures should take into account that domestic sovereign debt serves multiple purposes in banks´ balance sheets (aside from being a cornerstone for liquidity regulation compliance). For example, domestic sovereign bonds are a key component for interest rate risk management because it is the asset class that most closely matches the interest rate sensitivities of banks' domestic liabilities and does not generate additional credit risk. Without this exposure to domestic sovereign debt, banks would be forced to hedge interest rate risk with third parties, generating additional costs and counterparty risks. Penalising these holdings (via an increase in risk weights or concentration limits), without a viable alternative, could have far-reaching consequences for banks' risk profiles, as well as for sovereign debt markets, cross-border flows and the smooth-functioning of the global economy.

Secondly, a fully-fledged European Deposit Insurance Scheme (EDIS) in the steady state is essential for the completion of the BU. The third pillar has always been recognised as a fundamental piece since the inception of the BU. The political deadlock on this field should urgently be overcome. The current economic conditions are favourable and the brunt of the risk reduction across the banking sector has already taken place. To name just a few but clear examples: significant improvements in banks' capital positions, higher provisioning, reduction of NPLs and substantial progress in the build up of the Single Resolution Fund (SRF) and the political agreement for its backstop. Consequently, the current window of opportunity can and should be used now.

> *"When analysing options to advance in breaking the sovereign-bank loop, policy makers should consider all the different angles and spillovers."*
>
> \- DAVID VEGARA

Finally, regulators should also address the barriers that currently prevent a smooth functioning of the different pillars. There is an urgent need to close the loopholes in the Single Rulebook, in supervision and resolution. >>>

>>> In conclusion, when analysing the different options to advance in breaking the sovereign-bank loop, policy makers should consider all the different angles and potential spillovers. More so in a context where several national disparities that affect the banking system coexist across Europe, ranging from taxation, accounting and auditing, to insolvency laws, pension frameworks and housing finance. Taking a pragmatic and holistic approach and completing the banking union with a fully-fledged EDIS seems a sensible way forward that should foster cross-border integration in the sector and further reduce risks to financial stability. ●

Søren Holm

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P2G and regulatory leeway is key in breaking the sovereign-bank loop

The European Union has made significant progress towards removing the risk of painful resolutions and bailouts stemming from the sovereign-bank loop. This includes the creation of the banking union, the CRR/CRD, the recent risk reduction package, and tougher requirements for SIFI's – especially regarding own funds and MREL-requirements. Notably, CRR already treats externally rated banks according to their own rating rather than the sovereign rating when determining risk weights. Further, the finalized Basel III recommendations removes the sovereign rating approach when determining credit risk of exposures to unrated institutions as well. Last and most important, the CRR2/CRD5 Pillar II framework becomes much more transparent when split into the Pillar 2 Requirement (P2R) and Pillar 2 Guidance (P2G).

It is obvious that banks should not be able to drag down states at the tax payers' expense, but the other way around the loop is much more difficult – if not impossible – to break; the resilience of banks will per definition be a mirror of the macroeconomic health of the states that they operate in. Thus, when regulators are seeking to break the sovereign-bank loop, on one hand they should focus on regulatory leeway for banks operating in different macroeconomic scenarios. While, on the other hand, individual capital requirements based on stress testing of the economic cycles of the individual bank's specific exposures – including holdings of liquid assets – is the basic tool for improving the banks' resilience.

Regulatory leeway should be created so banks with a lower credit quality step (notably step 2 and 3) are recognised as valid participants in the real economy, e.g. as deposit takers, and guarantee or derivative counterparties. If regulation is too rigid and only recognises minimum AA-rated banks as eligible counterparties in the financial system, the potential need for sovereign interference even in "normal" economic downturns will be much higher. It also impedes the continued development of cross border European banking and capital markets.

The new Pillar 2 framework is the toolbox for individual capital requirements. However, stress testing should be the main corner stone in the further development of Pillar 2 Guidance, i.e. the specific exposures in states or markets on the top of the economic cycle should be tested towards an economic downturn. Resilient banks always have access to liquidity. Changing liquidity requirements – e.g. further diversification in liquidity holdings – will not itself reduce the total systemic financial risk. On the contrary, it may even be detrimental to the market liquidity of HQLA markets.

Therefore, we should recognize even BBB-rated banks as eligible counterparties in regulation, and strengthen the framework for banks' individual capital requirements. These initiatives would ensure a more robust financial system on its own, thus serving to ease the magnitude of the sovereign-bank loop. ●

Jesus Saurina

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About loops, alleged loopholes, and the real missing pillar of the Banking Union

The global financial crisis showed the impact that banks' problems may have on sovereigns. A too low level of capital and too much risk lurking in the balance sheets of a number of European banks, led to their rescue using taxpayers' money. Bail outs in Europe were necessary to protect bank depositors, avoid contagion and reassure financial stability. But the funds used for those rescues put a significant pressure on some sovereigns, which had to be supported using European programs. This link created between banks and sovereigns should have diminished significantly as regulatory reform and supervisory action increased capital requirements, reduced NPLs and improved governance and risk awareness by banks. Moreover, from now onwards, MREL funds should be used to bail in banks instead of taxpayers' money. >>>

>>> Banks hold a diversified portfolio including loans to households and firms as well as equity and sovereign bonds. The level of risk of banks' assets varies significantly, with sovereign bonds being one with the lowest risk. Defaults of advanced economy sovereigns are extremely rare events since WWII, as empirical evidence shows. Bank holdings of sovereign bonds are countercyclical, that is, increase during recessions when private sector lending is too risky and sovereigns offer a safe harbor. When the economy recovers, banks again focus their lending on the private sector, which delivers a higher expected return. In the last decade, including stress periods, the CDS premia correlation between sovereigns and banks and between sovereigns and non-financial firms, whose balance sheets are free from sovereign exposures, was pretty similar. Therefore, the market perception of banks' risk seems more related to the prospects of the economy than to the amount of sovereign exposures in their portfolios. The collapse of a sovereign has far more reaching effects than the exposure of banks to it, which underlines the importance of a sound fiscal policy.

"Regulatory treatment of sovereign exposures...quite less urgent than...a fully-fledged EDIS."

\- JESUS SAURINA

Moreover, sovereign bonds are a key instrument to manage bank liquidity given the depth of their markets. Last but not least, during the sovereign bond stress period undergone by some euro area peripheral countries, banks sovereign holdings played a key stabilization role. All in all, the relationship between sovereigns and banks is much more complex than the simple amount of exposure held in banks' balance sheet.

Regulatory treatment of sovereign exposures has been discussed in Europe for a long time, as well as at global level. The Basel Committee issued a discussion paper more than a year ago setting out some ideas. There is no consensus on the way forward on this very complex matter among international regulators. A significant number of them are against changing the current treatment of sovereign exposures, in particular those from advanced economies outside continental Europe and from emerging countries worldwide. Certainly, this issue might be more relevant to be discussed among Banking Union countries, in a context of risk reduction and risk diversification. Nevertheless, it seems quite less urgent than finalizing the Banking Union by implementing a fully-fledged EDIS (European Deposit Insurance system). ●

Benjamin Angel

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The sovereign-bank nexus: where we are and where we go from here

The euro area debt crisis brought to the spotlight how much banks and their sovereigns are intertwined. Many experts and practitioners knew about it; however, the extent and implications of this phenomenon, including for the stability of the common currency itself was not fully appreciated until 2012. Since then, loosening the nexus and mitigating its potential to endanger the stability of the common currency have been primary goals of EU policy-makers.

Obviously, crisis prevention on the sovereign side requires prudent economic and budgetary policies. A lot has therefore been invested in strengthening macroeconomic and fiscal surveillance in the EU and the euro area. However, turbulences on sovereign debt markets can still occur. Loosening the nexus between banks and their sovereigns is therefore still of utmost importance.

Of course, this is no easy task. We are talking about reshaping one of the most fundamental and longstanding relationships in our financial system. Hence, we have been developing a comprehensive list of projects that takes into account both the economic necessities and the political realities of today, in order to meet this challenge.

The first measure was to reduce banks' leverage and strengthen capital. This reduced the importance of the sovereign implicit guarantee for the system's liabilities. Then, in 2012, the Single Supervisory Mechanism was created to ensure a consistently prudent approach in supervision across the euro area.

With the Single Resolution Fund (SRF), we have created a European counterparty to banks in the event of a crisis and hence loosened the nexus significantly. The European Deposit Insurance Scheme (EDIS), once agreed, will follow the same logic. Consequently, with the ESM-based backstop to the SRF agreed in December last year, one can say that euro area banks are becoming today European "in death".

However, loosening the nexus also calls for them to be genuinely and persistently European "in life". This requires inter alia tackling the disincentives to cross-border diversification including its costs. This is the prime rationale for the Capital Markets Union initiative, admittedly a rather long-term project.

"Loosening the nexus and mitigating its potential to endanger the stability of the common currency."

\- BENJAMIN ANGEL

Should we go further and incentivise banks to go cross-border by means of regulation i.e. by reforming to the regulatory treatment of banks' sovereign exposures (RTSE)? This is certainly not an easy question. On the one hand, the liquidity and accessibility to non-resident investors of >>>

>>> sovereign debt markets make them a very efficient vehicle for cross-border asset diversification. On the other hand, those markets are the backbone of our entire financial and monetary system. We need to err on the side of caution especially when some Member States' high debt loads make them vulnerable to possible adverse market reactions.

Many options have been assessed over the years, ranging from no change to introducing a standard approach for risk weights and exposure limits.

Radical changes are unlikely, either because they would be financially very disruptive (e.g. aligning the RTSE on the standard approach) or because there is not yet enough political consensus (e.g. establishing a common European safe asset).

It does not mean, however, that nothing can be done. Taking domestic exposure into account when calculating bank contributions to the EDIS, for instance, would not introduce disruptive practices or mismatches between the European and the international regulatory approach. ●

Burkhard Balz

Member of the Executive Board, Deutsche Bundesbank

Keeping the Banking Union healthy requires a tackling of sovereign risks

The necessity to break the sovereign-bank loop is the most important lesson learnt of the financial crisis. The illness named sovereign crisis was identified quickly, but the healing is not yet completed.

The healing is a duty of the Member States to begin with. Since the introduction of the euro 20 years ago the deficit criterion of the stability and growth pact has been missed more than 100 times. As of today, only 7 out of 28 Member States are compliant with the debt criterion of the stability and growth pact. It is obvious that the roots of the sovereign-bank loop go deeper than revising the Banking Union legislation only. The economic governance framework has to be improved so that its transparent and rules-based application is ensured. A politically independent authority could be mandated with the monitoring and enforcement of the framework.

One initial step can be done when revising the ESM. The ESM could act upon its coordination role in the debt restructuring of Member States in order to positively contribute to a stabilisation of the economic and financial system when the refinancing conditions of a Member State are challenged. An automatic prolongation of sovereign bonds holding periods to another three years could be helpful, once the Member State enters an ESM programme. Firstly, such an approach would ensure that the creditors remain responsible for the investment decisions they have taken, secondly, fire sales of sovereign bonds could be prevented, and more time would be granted for setting up a credible economic programme for the Member State in distress.

> *"A completion of the Banking Union has to tackle the privileges for sovereign bonds."*
>
> \- BURKHARD BALZ

At the same time, while crisis-solving measures such as possible ESM tools are relevant during crisis situations, the prevention of the emergence of a new sovereign crisis is what should concern us the most today. Banks in Europe still have a highly concentrated risk exposure in domestic sovereign bonds. They have no limitation in the amount of bonds they can hold or an explicit capital requirement for their exposure. As long as this is the case, the financial health of banks and sovereigns remains highly intertwined. A sharing of bank risks therefore indirectly implies a sharing of fiscal risks, which would be in contradiction to the principle of Member States' liability in European economic governance. A completion of the Banking Union which claims to be equally based on risk sharing and risk reduction therefore has to tackle the privileges for sovereign bonds and provide comprehensive solutions for addressing the risks in relation to sovereign exposures. Weakening the sovereign-bank nexus is of course easier said than done. Nonetheless, with the international standard-setting being hesitant on progressing with the treatment of sovereign exposures, it is now on Europe to decide whether it wants to heal. ●