Sovereign / financial sector / Central Bank loop

Andreas Dombret

Adjunct Senior Research Scholar, Columbia University

Sovereign-bank nexus still needs to be addressed 11 years after the global financial crisis

Over the years since the collapse of Lehman Brothers in 2008 significant progress has arguably been made on many fronts of the regulatory agenda. The most important regulatory measure to date was agreeing on the Basel III framework, which has introduced, amongst others, much stricter capital requirements and new liquidity rules on a global level. With full implementation of the Basel III rules, regulatory capital requirements will be significantly higher and, at least equally important, capital will be of higher quality than under the Basel II regime. All of this represents considerable progress and is bound to make the financial system much more stable than before, yielding to increased trust amongst market participants. The calculation is quite simple and, at the same time, rather convincing: More equity that can absorb losses and helps mitigate risks makes banks, and thus the entire financial system, a safer place.

> *"Let's kick-start a paradigm shift to end the regulatory privileges of sovereign exposures."*
>
> \- ANDREAS DOMBRET

But has the sovereign-bank nexus been broken by Basel III? Are higher capital and new liquidity requirements enough to effectively safeguard financial stability? Can the international financial community lean back and argue that the job is done? Certainly not. An example that is a rather good illustration of the limits of capital as an all-purpose tool is the still unsolved regulation of sovereign exposures. And these sovereign exposures are directly linked to the sovereign-bank nexus Europe experienced, again, from May 2010 onwards.

Under the current regime, banks do not need to hold any capital against the risks associated with loans to sovereigns - unlikely any other loan category or asset class. This is based on the assumption that loans present itself as a major cluster risk because the default of a sovereign as single debtor can well cause bank insolvency with wide spread consequences.

>>> Consequently, changing the rules appears imperative to me any many others, both inside and outside of Europe. If banks actually were required to hold adequate capital against the risks of their government bond portfolios, they would be much more resilient to financial distress. And at the same time, banks would have less financial incentive to acquire large volumes of domestic and international government bonds if these were not privileged any longer, or less privileged. Furthermore, this may well incentivise governments to reduce their overall debt.

The second important issue that regulators and policy makers need to tackle is diversification - as specified in the Basel large exposure regime which took effect on January 1st of this year. Large exposure caps, once introduced, would prevent banks from becoming overexposed to a single borrower and the risk of its default. Currently, the regime is restricted to private borrowers, and sovereign bonds or loans do not fall into its scope. It is important also to end this regulatory privilege and to create a true level-playing field for both private and sovereign borrowers alike.

Therefore, many believe a cap on loans to an individual sovereign is badly needed and also should be introduced, and I agree with them.

As an international agreement seems rather unattainable at present I believe it therefore to be all the more important to move forward at the European level and to kick-start a paradigm shift to end the regulatory privileges that sovereign exposures still enjoy today.

Akira Otani

Deputy Director-General,
Bank of Japan

Possibility of an adverse feedback loop in Japan

Would Japan face an adverse feedback loop among the government, central bank, and financial institutions? In Japan, the government debt to GDP ratio is 230%. A large part of Japanese government bonds (JGBs) is held by the Bank of Japan (BOJ) and Japanese banks: BOJ and Japanese banks hold 46 % and 17% of JGBs issued, respectively. This situation seems to meet prerequisites of the materialization of an adverse feedback loop.

"An adverse feedback loop would not materialize in Japan in the foreseeable future."

\- AKIRA OTANI

In fact, some economists think the answer to the question could be yes. They regard the BOJ's exit from its ultra-accommodative monetary policy, by which the 10-year long-term interest rate is controlled at around 0%, as one of the potential triggers of an adverse feedback loop. It would sharply raise the long-term interest rate. An increase in interest rate would not only increase interest payments by the government but also induce public funds injection into the BOJ to make up for losses from its JGB holdings. In addition, Japanese banks' possible losses from JGB investments caused by an increase in interest rate could exert negative downward pressure on economic activity >>>

>>> through worsened financial intermediation function. This mechanism would further deteriorate the government fiscal position, resulting in more rise in the long-term interest rate.

I think, however, an adverse feedback loop would not materialize in Japan in the foreseeable future. Behind my assertion lie the following four factors:

- Even when the BOJ exits from its ultra-accommodative monetary policy, the long-term interest rate would not rise sharply but moderately. The BOJ would maintain a massive amount of JGBs on its balance sheet. This stock effect would constrain an upward pressure on the interest rate.
- The Japanese government reiterates its commitment to maintaining fiscal discipline. In addition, when the BOJ implements its exit strategy exits, we should have higher inflation and nominal growth rate. Nominal GDP, which determines the size of tax revenue, will grow faster than the pace of increase in the government's interest payments on JGBs, which have long maturities. As a result, the government's debt to GDP ratio is projected to decline even after the BOJ's exit.
- The BOJ makes provisions against the possible losses from its JGB holdings.
- Japanese banks continue to diversify their portfolios, ranging from JGBs to riskier assets, under the prolonged low interest rate environment. Under such circumstances, in case of 100bps increase in the long-term interest rate -- of which assumption is fairly severe taking account of the stock effect from the BOJ's JGB holdings -- the losses of Japanese banks' JGB holdings are estimated to account for 10% of their capital. Therefore, their capital adequacy ratios remain to exceed the regulatory required ratio.

Considering that the adverse feedback loop is not a candidate for destabilizing financial system, what is the major risk to financial stability in Japan? The reasonable answer would be the long-lasting low profitability of Japanese banks. It is caused by structural factors such as the decrease in growth expectations and the secular decline in loan demand associated with the shrinking population, as well as the prolonged low interest rate environment. In response to the decline in their profitability, major banks have aggressively expanded their global activities. Regional banks have become more active in domestic lending to middle-risk firms and the real estate industry, as well as in securities investment. However, as they have generally not been able to secure profits commensurate with the increase in risk-weighted assets, their capital adequacy ratios and stress resilience have declined moderately. Should this situation persist, downward pressure on the real economy from the financial system could intensify in the event of stress, as the capital of financial institutions would decrease substantially due to increased credit costs and securities-related losses. •

Klaus Kumpfmüller

Executive Director, Austrian Financial Market Authority

Addressing the sovereign-bank loop: setting the right incentives in the Banking Union

We have undoubtedly made progress in fostering financial sector resilience since the onset of the financial crisis. However, progress has focused more strongly on the liabilities side of the balance sheet: capital ratios and the quality of banks' capital have improved significantly. Similarly, Solvency II has increased the robustness of the insurance sector. Of course, progress made on the asset side should not be overlooked. Tough new rules have been agreed at European level to tackle legacy risks and NPLs. With some assistance from a favourable economic environment, NPLs are decreasing throughout the EU.

However, we have to acknowledge that work still needs to be done to complete the Banking Union. Concentration risks in sovereign exposures remain a critical link in the sovereign-bank nexus. 8 years on from the sovereign debt crisis, and the balance sheets of financial institutions still contain roughly the same level of sovereign exposures. The home bias remains strong in many Euro Area member states, ranging from less than 3% to up to 91% of sovereign bonds held by domestic banks. >>>

>>> Sovereign bonds are, and will remain, an important asset class in banking and insurance business. This should be respected and accepted. Still, tackling the home bias in sovereign bond holdings is an important milestone towards completing the Banking Union. European Banks must be European in their sovereign exposures – less home bias, more European focus. With the economic cycle maturing, we should start setting the right incentives. Euro Area banks should be incentivised to hold a well-diversified Euro Area sovereign bond portfolio. To achieve this, only well-diversified sovereign portfolios should continue to fully enjoy the privilege of zero risk-weights. Overly concentrated portfolios should be subject to own funds requirements for disproportionate exposures to any Euro Area member state.

In practice, excessive exposures could be determined by measuring a bank's portfolio against a benchmark portfolio. The benchmark could be the distribution of sovereign exposures based on the proportion of a member state to Euro Area GDP. Thus, own funds requirements would only apply to exposures substantially exceeding the benchmark shares.

"European Banks must be European in their sovereign exposures – less home bias, more European focus."

\- KLAUS KUMPFMÜLLER

Ultimately, the effects should be largely reciprocal throughout the Euro Area: a bank based in one-member state would be incentivised to shift its disproportionately high sovereign exposure to other member state debt that is hitherto underrepresented in its portfolio. The details of such an approach would need to be carefully calibrated to achieve the aim of effectively reducing concentration risks in sovereign exposures, while simultaneously not penalising the financial sector for holding Euro Area sovereign debt.

It is in our mutual interest to finally break the link between bank and sovereign crises in Europe. To resolve the deadlock on the question of generally applicable risk weights for sovereign exposures, we should embrace an evolutionary approach both with regard to EDIS and the treatment of sovereign exposures. We should start moving towards these goals in small, mutually reinforcing steps. However difficult, it remains a common responsibility of all stakeholders to find a reasonable treatment for sovereign exposures. ●

Bernard de Longevialle

Head of EMEA Financial Services, S&P Global Ratings

The risk of negative feedback loop has not been addressed

The negative feedback loop between sovereigns and domestic banks in a financial shock has been a key priority for EU regulators and policymakers. However, progress has been partial at best.

We certainly do not rule out the possibility of future banking crises, so the attendant fiscal cost of 'lost' GDP remains a key risk. However, we do see banks as safer thanks to more-demanding capital, funding and liquidity requirements and the ECB/SSM's proactivity in catalysing the balance sheet clean-up. Regulators now rightly try to strike the delicate balance between strong balance sheets and strong businesses, but we do not see the two as mutually exclusive.

Resolution will mean that even if systemically important banks fail, they are less likely to weigh on the taxpayer. Resolvability is admittedly a huge undertaking to deliver but relies heavily on adequate bail-in and funding resources. These resources are not yet in place and, without them, EU banks and their regulators will remain in an awkward position--halfway between the eras of bail-out and bail-in.

Banks' intrinsic creditworthiness is rarely stronger than that of their sovereign. But we see these positive vectors combining in Italy, where we now anticipate that UniCredit could be more resilient to sovereign default. However, seeing even strong banks rated above their sovereign will remain an extreme rarity while they retain a heavy domestic focus and continue to invest heavily in domestic government debt. On this last point, very little has changed – neither for banks, nor for insurers.

Bank capital rules continue to encourage many banks to retain bulky exposures to their domestic sovereign. In the Eurozone, we find that banks' exposure to their home sovereign was on average about 74% of banks' Tier 1 capital as of September 2018, with big variation by country. This is down from 107% as of end-2014, but domestic sovereign defaults could still wipe out large parts of many banks' regulatory capital bases. By contrast, the banks' post-crisis retrenchment to their domestic markets has amplified the weight of their domestic loan exposures.

European insurers face similar exposure to the negative feedback loop with their respective sovereigns as banks, although the risk to their credit ratings is less pronounced. They too are incentivized by regulatory capital rules to hold domestic and Eurozone sovereign debt, particularly those utilizing the Solvency II standard formula with its 0% risk weights and need to hold long duration assets. Median exposure for eurozone insurers is around one-third of total investments, but again with huge national differences.

Circumstance plays its part also. In a low yield environment, banks (in their treasury assets) and insurers (in their investment of life premiums) cannot afford to focus their investments only on negative yielding assets. And yet they need to find assets that qualify for liquidity buffers and do not accentuate investment risk for policyholders.

Will this fundamentally change anytime soon? We see no reason to think so. ●

Dino Kos

Chief Regulatory Officer, CLS

Acting now before the inevitable storm – The sovereign-bank nexus

The regulatory treatment of sovereign exposures is not a new issue. The Basel Committee struggled with the subject going back to the initial Basel Accord in the late 1980s. Back then, the question was whether some or all sovereign exposures should be zero risk weighted. More recently, the inadequacies of the current approach have been linked to the "sovereign-bank nexus" and again elevated this issue to the forefront of the post-crisis policy debate.

The result was a flurry of activity by international standard-setting bodies and experts, but the full scope of the issue has yet to be resolved. Notably, notwithstanding years of work, in 2017 the Basel Committee could not reach consensus on how to change the regulatory treatment of sovereign exposures. A public consultation never left the door. The Basel Committee's discussion paper on sovereign risk labeled proposed changes to the regulatory treatment of sovereign exposures as "potential ideas" rather than "recommendations". Capital regulations continue to allow preferential treatment of sovereign exposures.

While addressing the sovereign-bank doom loop is difficult, promising ideas have been put on the table. Some combination of adjusting risk weights and, more importantly, adopting concentration limits on sovereign holdings provides a way forward to reduce this risk over time. What is required is urgency and action. So what is holding back progress now – nearly a decade since the onset of the Greek crisis that first elevated this risk?

Ironically, market pressure has eased as the demand for sovereign debt has surged. Thirteen EU Member States, plus Switzerland and Japan, have negative yield on government debt securities with maturities of up to five years. Many of these have negative yields out to 10-year maturities.

Governments have no difficulty financing themselves and have taken advantage to issue large amounts of debt, despite an overall deterioration in sovereign ratings. As sovereign yields have fallen, so have borrowing costs for banks. In the short-run, negative yields relieve the pressure to act. As yields have gone deeper into negative territory, the value of the bonds banks hold has increased – and is actually helping balance sheets – for now.

> *"Current benign environment is a window of opportunity to act before the inevitable storm moves in."*
>
> \- DINO KOS

However, in the medium to long-run, the current negative rate environment is unlikely to persist. Any number of factors could cause a reversal. The market is increasingly like a coiled spring that, when released, could set off a rapid and disruptive upward lurch in bond yields.

The time to address the regulatory treatment of sovereign exposures is now. Not only are proposed solutions out there, but the current benign environment is a window of opportunity to act before the inevitable storm moves in . As JFK once said, "There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction."

The views outlined in this article are my own and do not reflect the views of CLS. ●

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