ADDRESSING THE SOVEREIGN / FINANCIAL SECTOR / CENTRAL BANK LOOP IN THE EU

The sovereign debt crisis that erupted in the euro area in 2010 highlighted again the fact that bank risk and sovereign risk are closely intertwined. Sovereigns were indeed exposed to banking risk, and banks were exposed to sovereign risk.

Therefore, a major objective of the Banking Union was to weaken the feedback loop between banks and sovereigns so that increases in banks' credit risk would no longer be reflected in sovereign risk and, conversely, banks' financing costs would no longer be driven by their sovereign's creditworthiness.

However, 7 years after its creation, the Banking Union has not succeeded in breaking this vicious circle. The quantitative easing policy of the ECB has even extended this loop to the central banks with large holdings of government bonds purchased. A solution could be a change in the regulatory treatment of sovereign exposures but there is no momentum for changing this framework. Fiscal discipline would therefore be the main component of a possible solution for reducing this sovereign-bank loop.

1. The feedback loop between banks and their sovereigns escalated the financial crisis in Europe into a sovereign debt crisis

The sovereign debt crisis that erupted in the euro area in 2010 highlighted again that bank risk and sovereign risk are closely intertwined. In some countries (Ireland, Spain), the problems arose from a major and unsustainable growth in bank lending, as well as from poor risk management. In these countries, the central government had to provide substantial financial assistance in order to prevent a collapse of the banking sector that would have shaken the whole financial system. In countries where the root cause of the problems was excessive government indebtedness (Greece, Italy, Portugal), domestic banks ultimately ensured their sovereign's access to financing. In both cases the outcome was identical: both banks and the sovereign ended up in significant distress, and external financial assistance was required to solve the problem.

In other words, domestic bank risk can weaken a country's public finances in case troubled banks require government support, while domestic sovereign risk can weaken bank balance sheets through banks' holdings of government debt. The feedbacks between bank and sovereign risks can lead to a `doom loop', as a result of which both banks and their sovereigns can end up in a crisis simultaneously.

The Banking Union was precisely designed to weaken this feedback loop between banks and their sovereigns. 7 years after its creation, it is appropriate to consider whether progress has been made in this area.

2. Banks' exposures to their sovereigns are still significant in certain high-indebted countries (Italy, Spain, Portugal)

The ESRB report on the regulatory treatment of sovereign exposure (March 2015) and the CEPR analysis of M. Lanotte and P. Tomasino[1] show that in most euro area countries, euro area sovereign debt exposures of banks (as a proportion of total assets) were considerably larger at the inception of the Economic and Monetary Union than they are now.

After a reduction in the first half of the 2000s, banks in stressed euro area countries have gradually increased their euro area sovereign debt holdings again (as a proportion of total assets) in the last eight years (***see Chart 1***). In contrast, banks from other euro area countries either continued to reduce or stabilised their euro area sovereign debt exposures[2].

In almost all euro area countries, the euro area sovereign debt exposure of banks is overwhelmingly towards their domestic issuer, and this home bias is particularly strong in the countries where banks' total euro area sovereign exposure is largest (as a proportion of total assets)[3].

In general, banks in stressed euro area countries increased their exposure to domestic sovereign debt in response to increases in its yield. This response may have been motivated by different factors, including banks' search for yield by engaging in carry trades that take into account redenomination risk, the desire to increase holdings of liquid assets etc. For a more limited range of countries, there is also some evidence that banks in stressed countries increased their sovereign exposures in response to worsening domestic macroeconomic conditions.

According to the IMF[4], almost 60 percent of French, German, Italian, and Spanish banking groups' exposure to euro area sovereigns, for instance, is concentrated in securities issued by the home sovereign. Similarly,

[1] M. Lanotte and P. Tomasino, "Recent developments in the regulatory treatment of sovereign exposures", VOX, February 2018.

[2] According to the ESRB study, there is no significant difference between sovereign exposures held by systemically important financial institutions (SIFI) and non-SIFI.

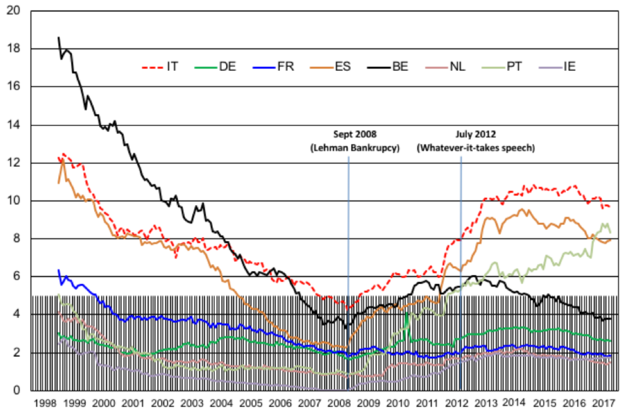
[3] Italian banks are the most exposed in Europe, holding €387bn of domestic sovereign debt, equivalent tp about 10% of their total assets, according to data from the ECB.

[4] IMF, Euro area policies, article IV, July 2018.

60–80 percent of French, Italian, and Spanish Insurance companies' investments in sovereign debt are in home-country bonds.

Whatever the motive, the exposure of banks in stressed euro area countries to domestic sovereign debt has increased concurrently with an increase in the risk of such debt, therefore increasing risk in these banks' balance sheets and reinforcing the banks-sovereign link, which is itself a source of systemic risk.

Chart 1 Banks' holdings of domestic sovereign bonds

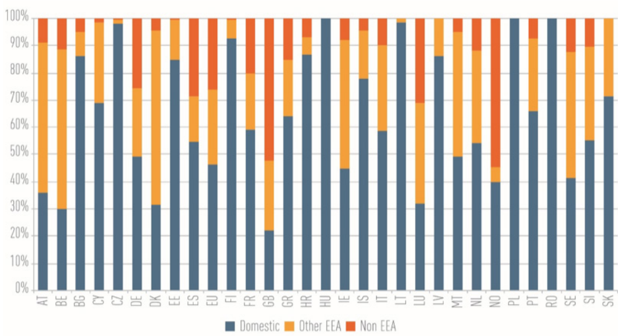


Note: Percentage of banks' assets; based on Eurosystem data.

Source: M. Lanotte & P. Tommasino analysis

According to the Risk Assessment of the European Banking System issued by the EBA in December 2018, exposures to general governments have declined in particular since June 2016. Total sovereign exposure of the EU banking sector stood at EUR 3.0 tn as of June 2018, a 2% decrease compared with June 2017 and a 10% decrease compared with 2 years ago. On EU average, nearly 50% of these exposures were towards domestic counterparties (June 2018), with significant dispersion across countries. For the vast majority of these countries, foreign sovereign exposures are mostly concentrated in EEA countries, with the exceptions of Norway and the UK, where banks have at least 50% of their total exposures towards non-EEA countries (***Chart 2***).

Chart 2 Country distribution of exposures to general governments by their domicile – June 2018 (domestic, other EEA and non-EEA)



Source: EBA supervisory reporting data

According to EBA, on average, 65% of a medium sized bank's Tier 1 capital is on the domestic sovereign, but in the whole distribution there are banks which have up to eight or nine times their Tier 1 capital on domestic sovereign.

3. The sovereign doom loop also affects central banks with large holdings of government bonds purchased as part of QE programs

The quantitative easing policy of the ECB has led to a doubling of the Eurosystem's balance sheet from €2,150 billion at the end of 2014 to €4,620 billion in September 2018. As a result of the Public Sector Purchase Programme of the ECB, the share of government bonds held by NCBs surged in the last three years from around 5% to 15-20% of total outstanding government bonds, as illustrated in ***Table 1***.

But this policy has not reduced the vicious circle between Sovereign and banks in euro area highly indebted countries, as explained above. On the contrary, quantitative easing programs encouraged institutions to borrow cheaply from central banks and invest in government bonds with higher returns. In addition, in Italy, the end of the European Central Bank's QE program and domestic political instability — have increased the problems of financial institutions already laden with significant nonperforming loans.

The linkages between governments and banks are now extended to central banks and this casts a special light on the independence of the central banks.

Table 1 General Government debt held by the Eurosystem (as % of government debt)

	BE	DE	SP	FR	IT	PT	EA19
mi-2019	15.8	20.1	22.4	18.8	19.3	18.9	19.6
2018	16.1	19.9	22.9	19.1	19.3	19.4	19.7
2017	15.5	17.4	21.4	18.5	19.3	19.0	18.7
2016	11.8	12.1	16.3	14.8	15.5	17.4	14.4
2015	7.5	6.0	10.6	9.7	11.3	14.0	9.3

Source: ECB monetary statistics, Eurostat

In any case, the normalization of the monetary policy of the ECB should be very challenging in the absence of structural reforms in these highly indebted Member States and could still reinforce the sovereign- domestic bank nexus.

4. At the global and EU levels, there is no momentum for changing the regulatory treatment of sovereign exposures

For decades, the regulatory treatment of sovereign debt has significantly discounted and, in many cases, ignored the possibility of default on exposures that are denominated and funded in the country's own currency

In most cases, the existing treatment of sovereign exposures is more favourable than other asset classes. Most notably, the risk-weighted framework includes a national discretion that allows jurisdictions to apply a 0% risk weight for sovereign exposures denominated and funded in domestic currency, regardless of their inherent risk. This discretion is currently exercised by all members of the Basel Committee on Banking Supervision. Sovereign exposures are also currently exempted from the large exposures framework. Moreover, no limits or haircuts are applied to domestic sovereign exposures that are eligible as high-quality liquid assets in meeting the liquidity standards. In contrast, sovereign exposures are included as part of the leverage ratio framework.

EU policy makers urged regulatory actions on EU sovereign doom loop

The SSM said last year that it was vital that banks' capital regimes should reflect the risks they were taking when they held the sovereign bonds of less secure countries. The EU Commission also stressed that the eurozone should think about the concentration charges above a certain level of retention of the home sovereign. The Bundesbank has repeatedly urged regulators to impose limits on the amount of their own government's bonds that banks can hold on their balance sheets. The German Central Bank views the weakening of the sovereign bank nexus as vital for a more solid Banking Union and is reluctant to back measures such as a Europe-wide insurance scheme for deposits (EDIS) without such limits.

The Basel Committee published a discussion paper on the regulatory treatment of sovereign exposures in December 2017, but it did not reach a consensus on making any changes to the regulatory treatment of sovereign exposures

In a discussion paper issued for comments in December 2017, the Banking Committee on Banking Supervision set out some ideas regarding the regulatory treatment of sovereign exposures. It started by reviewing the existing perimeter and segmentation of sovereign exposures and presented the Committee's discussions on possible revisions to the definition of sovereign entities to ensure greater consistency across jurisdictions. It then outlined ideas related to revising the regulatory treatment of sovereign exposures. These can be grouped into three broad categories.

The first set of ideas relates to: (i) the removal of the internal ratings-based (IRB) approach framework for sovereign exposures; (ii) revised standardised risk weights for sovereign exposures held in both the banking and trading book, including the removal of the national discretion to apply a preferential risk weight for certain sovereign exposures; and (iii) adjustments to the existing credit risk mitigation framework, including the removal of the national discretion to set a zero haircut for certain sovereign repo-style transactions.

The second set of ideas relate to mitigating the potential risks of excessive holdings of sovereign exposures, which, for instance, could take the form of marginal risk weight add-ons that would vary based on the degree of a bank's concentration to a sovereign (defined as the proportion of sovereign exposures relative to Tier 1 capital).

The third set of ideas is related to the Pillar 2 (supervisory review process) and Pillar 3 (disclosure) treatment of sovereign exposures. Regarding the former, these include ideas related to guidance on: (i) monitoring sovereign risk; (ii) stress testing for sovereign risk; and (iii) supervisory responses to mitigating sovereign risk. Regarding the Pillar 3 framework, this paper includes ideas related to disclosure requirements related to banks' exposures and risk-weighted assets of different sovereign entities by jurisdictional breakdown, currency breakdown and accounting classification.

However, the Committee has not reached a consensus on making any changes to the regulatory treatment of sovereign exposures at this stage and has therefore decided not to consult on the ideas presented in the discussion paper. This has of course weakened the momentum for change in the EU because it would be contrary to maintaining an international level playing field issues.

In any case, proposals to reduce the bias, ranging from concentration charges to sovereign risk weights to risk-based premia for common deposit issuance, warrant careful consideration, with due attention to serious transitional risks in a context where the international banking regulatory framework (Basel III) creates further incentives for banking institutions to purchase sovereign debt (Liquidity Coverage Ratio…).

5. Fiscal discipline should be the essential feature of the required solution

When States are sanctioned by the market because of their excessive indebtedness, and when commercial banks are saddled with huge amounts of sovereign instruments issued by their country, the weakening of State ratings is automatically reflected in banking balance sheets. Fundamentally, the problem comes from lack of fiscal discipline, excess liquidity created by lasting loose monetary policy as well as from the lack of macroeconomic coordination, more than from banking weaknesses. Therefore, fiscal discipline in all parts of the euro area and in particular in high indebted countries would effectively improve sovereign debt sustainability and reduce the risk of sovereign-related distress.

The enforcement of the Stability and Growth Pact has been too lenient since 2003 EU. Despite the different reforms which took place after the sovereign debt crisis[5], the public debt ratio in significant European Union countries continues to increase and is approaching 100% of GDP or even more in certain Member States. Looking ahead, it should be ensured that compliance with the requirements of the debt reduction benchmark (60% of GDP) is not unduly delayed. Indeed, a monetary union is

[5] A reform (part of the 'Six-Pack') amending the Stability and Growth Pact entered into force at the end of 2011. Another one, the intergovernmental Treaty on Stability, Coordination and Governance, including the Fiscal Compact, entered into force in early 2013. A regulation on assessing national draft budgetary plans (part of the 'Two-Pack') entered into force in May 2013.

not workable without economic convergence and fiscal discipline. Fiscal rules need to be enforced more rigorously. By converging towards lower levels of government debt and regaining fiscal buffers, the euro area will increase its resilience and fiscal space to cope with potentially adverse economic shocks in the future.

Lastly, there is also an international dimension in the sovereign- bank nexus. Indeed, this nexus would weaken if banks were diversified across countries of the Eurozone. This is the reason why addressing the regulatory impediments related to cross-border banking in the euro area would significantly contribute to address the sovereign bank loop in the European Union. In this perspective, cleaning up rapidly the Non - Performing Loan issue and addressing the asymmetry between supervision and resolution at the EU level and, on the other hand, liquidation which is still handled at the national level remain essential EU regulatory priorities.