SOVEREIGN-BANK LOOP IN THE EU

The Chair reminded panellists that the debate would be organised as two rounds of questions: one dedicated to the diagnosis of the problem, i.e. where the industry stands, how this nexus has evolved and the drivers and channels of it; and one dedicated to potential ways to weaken the doom loop further.

1. The general evolution of the sovereign-bank loop and key challenges

A Central Bank official described how the relationship between banks and sovereigns was brought to the fore of the economic policy debate by the financial crisis. The regulatory and institutional reforms conducted since then have sought to reduce the probability and impact of a 'doom loop' between banks and sovereign risk, but weakening the threat posed to financial stability by that nexus seems to be 'easier said than done'. Indeed, in the second half of 2018, investors' concerns about this nexus were rekindled by the re-widening of Italian sovereign spreads. This might indicate that the nexus has not been weakened enough and, if this is the case, there is a question as to what additional policy tools should be used.

1.1. The sovereign debt crisis demonstrated that bank risk and sovereign risk are closely intertwined

Sovereigns are indeed exposed to banking risk, and banks are exposed to sovereign risk. Therefore, the 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.

An official felt that the situation is simpler than how it is often portrayed. First, banks reduced their sovereign debt holdings until 2006-2007. Banks bought each other's bonds and they were more diversified. However, the banking crisis became the financial crisis in 2008 (Lehman Bankruptcy in September 2008), which became in Europe the sovereign debt crisis (2009 – 2012). Banks saw their sovereigns getting into difficulty and anticipated increases in their future tax liability. Having no interest in being located in a bankrupt jurisdiction, banks rescued their home jurisdictions. They did what others would not: they acted against the supply and demand mechanism and bought sovereign-bonds. This problem involved a link between two weak entities: the banks, which became weak due to the banking crisis and even weaker because they bought state bonds; and the sovereigns, which were weakened due to the impact of the crisis. Logically, either the link between the two entities could be broken, or they could be made stronger. This second solution was clearly preferable. Europe did not try to break the link by imposing an arbitrary rule; it sought to strengthen both banks and sovereigns.

Another official agreed that banks played an indispensable role in the process of shock absorption, citing the example of Italy. When international investors retreated from the Italian market around 2011, within two years the Italian banks had increased their purchase of Italian bonds by €250 billion. Had they not done this, there would have been serious implications for the euro-area. The official added that Eurobonds were the best solution to this problem, but this was not politically possible at the time.

1.2. There are differences across EU member states, but banks' sovereign exposures are still elevated in many countries

An official considered that bank holdings of sovereign debt are an obvious and important channel through which the negative feedback loop between bank and sovereign risk can develop. A regulator noted that banks' sovereign exposures in Europe remain somewhat elevated. Given relatively high sovereign-debt levels, the resulting debt sustainability concerns and the low-growth environment, there are obvious risks to banks' balance sheets. The latest figures suggest that EU banks' sovereign exposures have fallen by approximately 10% or €400 billion over the last two years. Approximately half of this reduction concerns the holdings of domestic sovereigns among the individual banks. The median bank sovereign exposure relative to Tier 1 capital ratio in 2018 is approximately 170%, but within this observation there is a very wide distribution from banks with exposures of less than 90% of Tier 1 capital to banks with exposures of more than 250% of Tier 1 capital. Banks should be incentivised to manage sovereign exposure actively. The current prudential framework does not adequately incentivise banks to manage these exposures actively, given that banks can set zero risk weights on sovereign exposures. The lack of concentration limits for these exposures means it is vital for the competent authorities to monitor these exposures consistently and ensure that these vulnerabilities are well managed.

An industry representative considered that the debate about banks' sovereign holdings revolves around the dangers of having 'too many eggs in the same basket'. While the industry representative agreed that this could be a useful perspective, there are other more pressing issues the industry could be working on. The data suggests that European banks have significant domestic public- debt holdings, but the 'usual suspects', i.e. the banks in 'bad countries', are not at the top of this list. Sovereign exposures are essentially a generalised phenomenon. These exposures do not depend on the situation of the sovereign. Additionally, the industry representative stressed the importance of incentives. One consequence of the financial crisis has been a very substantial increase in the equilibrium level of liquidity demanded by economic agents, because economic agents have changed their demand function. The higher level of desired liquidity has impacted what substantiates this demand.

1.3. The sovereign-bank nexus extends to Central Banks

The sovereign doom loop also affects Central Banks with large holdings of government bonds purchased as part of Quantitative Easing programs. A regulator described how Central Banks' asset purchases are hold to maturity investments. By definition, they are insulated from day-to-day movements. Moreover, Central Banks have relatively advanced risk-management capabilities for managing exposures. Concentration risk-management is being carried out here. Additionally, Central Banks have exposures to sovereign risk because they accept this collateral in regular policy operations. In that context, Central Banks have very elaborate haircut schemes for sovereign paper of different quality and maturity, and they mark to market on a daily basis. In the banking sector, sovereign exposures can be assigned a zero-risk weight and are not subject to concentration limits. So, there is a big difference between what Central Banks are doing and what the banking sector is doing.

1.4. Sovereign debt serves multiple purposes in banks' balance sheets

An industry representative emphasised that the banks' business is not to invest in bonds. Banks invest in bonds to manage their balance sheet (aside from being a cornerstone for liquidity regulation compliance), among other issues. 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. Second, there now is a scarcity of safe assets. Third, banks, supervisors and regulators have 'too much on their plate'.

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. The industry representative felt that the debate over sovereign exposure is a way of avoiding a real debate on other policy or fiscal issues. The discussion unduly places a public-policy objective on the private sector.

1.5. The sovereign-bank nexus poses an important challenge for the whole monetary Union

A Central Bank official agreed that the sovereign-bank nexus posed an important challenge for the monetary union. The monetary union's unique institutional framework combines a single monetary policy with 19 autonomous fiscal policies. As long as member states are fiscally autonomous, sovereign exposures cannot be assumed to be risk-free. Fiscally, sovereign member states are responsible for their spending and revenue decisions. Ultimately, it is easier for member states to load up debt on the national banking system in times of crisis. Thus, a public-finance problem can be transformed into a problem for the entire banking system. This threat raises the pressure on Central Banks to come to the rescue, but Central Banks are restricted to the actions within their mandates.

1.6. Are sovereign exposures risk-free assets for banks?

A regulator felt that sovereign exposures are not risk-free for banks. Any sudden spread-widening can affect profitability and capital ratios. In particular, exposures measured at fair value are now vulnerable. EBA monitoring shows that about 40% of the banks' sovereign exposures are currently measured at fair value. Additionally, longer-maturity bonds are more vulnerable to spread-widening. A substantial majority of banks' exposures are in holdings with maturities longer than five years. On the other hand, extensive fair-value holdings and holdings with long maturities provide the market with disciplined mechanisms that work whenever and wherever needed.

A Central Bank official considered that the discussion on sovereign exposures is often passionate but lacks a technical dimension. While there may not be zero risk, sovereign default is not a high risk. Sovereign default is exceedingly rare in advanced economies; it is very low even for emerging economies. The Central Bank official reiterated the fact that banks' sovereign exposures are countercyclical. Banks want to lend to households and firms, because the return is higher. They invest in sovereigns during periods of crisis because private-sector exposures are too risky. Experience in Europe suggests that sovereign exposure decreases when there are opportunities for lending to households and firms. Empirical analysis suggests that the market's real concern is not total exposure levels but the general state of the economy. The relationship between sovereigns and banks is very complex. This relationship should be discussed in a holistic way and the discussion should include a wider variety of different elements.

2. The way forward: different points of view

2.1. Fiscal discipline is vital

A Central Bank official reiterated the importance of addressing the root cause of sovereign problems, which could only happen through fiscal discipline. Changing the regulatory treatment of sovereign exposures would be a less optimal solution. An official also agreed on the need for fiscal discipline. Banks should not pay the price for a state's mistakes. It is a 'fantasy' to suggest that the regulatory treatment of sovereign exposure could close the loop between sovereigns and banks. The holding of sovereign-bonds is one channel of transmission to the banks among many others. If a sovereign defaults, the economy will collapse by definition, and the bank's entire loan book will suffer. An industry representative echoes the comments made by other panellists, suggesting that the ultimate cause of these problems was a lack of budget discipline.

2.2. There is a need for European safe assets

An official highlighted the European Commission's proposal on sovereign-bond-backed securities in May 2018. While the reception of this idea was somewhat cold, there has been some progress. The European Parliament recently adopted a report on the subject. There were amendments to it, but this at least demonstrates some movement.

An industry representative noted the importance of safe assets, pointing out the unique role played by sovereign-bonds. There can be a debate over who issues these bonds in the context of monetary union and how they are described, but this is the reality of the situation. Either sovereign risk is linked to safe assets or the discussion is going nowhere. The industry representative regretted the fact that there is very little appetite in Europe for a pan-European safe asset. Domestic bias will continue to be an optimal strategy for banks as long as financial fragmentation continues to exist. If limitations on sovereign risk are imposed without addressing this, there could be unknown and serious spill-overs. The industry representative felt that a holistic approach is needed for incentives. At the micro level, public debt is not an issue of counterparty risk. It plays a key role in balance-sheet management, liability management, liquidity management, the structure of the balance sheet and the new regulatory framework. At the macro level, the industry must consider the impact on these elements.

Emphasising his belief that it is not apparent that anything has to be done about sovereign exposures, an official considered that there is no asset safer than government bonds. In the discussion of sovereign risk, it is important to keep in mind that the sovereign is the only body with a taxation power. More fundamentally, the very idea that a sovereign can default is an intellectually problematic one. The sovereign is the source of law. The sovereign can default, but this idea entails the body that is the warrant of the rule of law somehow compromising its own works.

2.3. Towards a change in the prudential treatment of sovereign exposures

A Central Bank official felt that the regulatory treatment of sovereigns had been discussed extensively in Europe. It started at the European Systemic Risk Board (ESRB), but the discussion ended up in the Basel Committee, which issued a discussion paper on the subject in September 2017. There is no consensus in Basel regarding the potential regulatory treatment of sovereign exposures. The regulators from advanced economies such as America, Canada and Japan have no appetite for it. This view is shared by regulators from the emerging countries. In Europe, however, there is a split. Some see particular merits in discussing the issue for Banking Union countries. This problem must be solved in order to advance the construction of Europe.

An official considered it positive that there is no support in Europe for 'normal' risk weighting and concentration limits, because this would seriously constrain the banking sector. It is possible to take an approach based on concentration charges, where moderate risk-weights would trigger at certain levels of exposure, but the success of this proposal will depend on the calibration of the instruments. An industry representative suggested that some action will be necessary if the industry cannot 'do the right thing'. As markets react to these issues, transparency is key. Banks should have to demonstrate market discipline, which would mean that banks' access to funding will be influenced by the way they are doing business. Regulators could also make more use of fair value. Connected to this is the need for stress-testing regarding either Pillar 2 or Pillar 2 guidance.

2.4. EDIS and the sovereign-bank loop: risk reduction should go hand in hand with risk-sharing

2.4.1. Much has been achieved to strengthen the resilience of EU banks

A Central Bank official reminded them that the global financial crisis demonstrated how banks with low levels of capital and high levels of risk sometimes have to be rescued by the taxpayer in order to protect depositors, avoid contagion and protect financial stability. Ultimately, the industry has learned from this experience and things have changed significantly. There has been a significant reduction in Non- Performing Loans (NPLs) at many banks in Europe and a significant increase in capital. Due to regulatory and supervisory pressure, there is an increasing consciousness of risk in banks and improved levels of corporate governance. Additionally, the Single Resolution Board (SRB) is starting to ask for binding Minimum Requirement for Own Funds and Eligible Liabilities (MREL) requirements from banks. The situation may not be perfect, but Europe's position has improved considerably since the crisis. The Central Bank official considered that many countries in Europe have done significant work on risk reduction but 'almost nothing' on risk-sharing.

An official felt that Europe has taken several positive actions. The Single Rulebook made the rules clear for all market participants, especially at the business level. Europe's resolution rules strengthened the system considerably and supervision was moved to the European level. Europe put more capital in the banks and increased the banking industry's loss-absorption capacity. The official noted the recent ECB study suggesting that the probability of default among banks had been reduced by one third. The amount of capital in the system has increased by approximately five times. Multiplying these two figures together, there has been a sevenfold increase in capital and liquidity. On the asset side, the level of NPLs has returned to its pre-crisis position. Instead of breaking the link between weak and connected elements, Europe sought to strengthen both banks and sovereigns. The euro-area crisis has been the first item of discussion at G7 and G20 meetings during 2011-2012, but the point has now disappeared from the agenda; there is no longer a systemic crisis. There are some banks with excessive sovereign exposures, but these are not the 'usual suspects'. There is no connection between 'bad banks' and 'bad countries'.

A Central Bank official agreed that strengthened banking regulation contributes positively to crisis resilience. The measures that were adopted have not interrupted the sovereign-bank loop, however. This link can only be broken by changing the regulatory treatment of credit and concentration risk. It is important for discussions to continue at the international level, because an international approach would be the best way to achieve a level playing-field. Timing and transitional periods are important, because the aggregation of cyclical risks should be prevented. An industry representative stressed the necessity of the European deposit-insurance scheme. Part of the industry can attempt to delay the EDIS debate, but Europe will not break the feedback loop between banks and sovereigns without EDIS. Additionally, greater transparency is essential. The real question in this debate is not about whether there should be limits on sovereign exposures but rather whether the industry could function without a safe asset. If the answer to that question is no, Europe must develop a sufficient pool of safe assets and perhaps develop fiscal union.

2.4.2. Completing the Banking Union

While there is an imbalance between risk reduction and risk-sharing, an official considered that the creation of the Single Resolution Fund (SRF) was an important element of risk-sharing. In any event, there are two reasons why a European deposit insurance scheme is necessary for the completion of the Banking Union: robustness and consistency. Europe needs robustness, because at least for liquidity it is necessary to have an instrument that can intervene very rapidly. Europe needs consistency, because it is very strange to have rules, supervision and resolution done at a European level but not depositors' protection.

A Central Bank official noted that addressing the sovereign-bank loop is a necessary precondition for a common deposit-insurance scheme. Such a scheme would improve the financial stability of the euro-area as it would reduce the risk of a bank run. However, as long as the sovereign exposures of banks are not subject to capital requirements and large-exposure regime rules, it will remain possible to shift public debt into the national banking system in times of fiscal stress. This means that a common deposit-insurance scheme would indirectly be tantamount to distributing this fiscal risk across the euro-area. An official noted that a number of member states had established a link between EDIS and the regulatory treatment of sovereign exposure, but there is no link between a deposit guarantee scheme and sovereign holdings.

2.4.3. Incorporating a sovereign risk consideration within EDIS

An official considered that there is a more logical solution to this problem. If sovereign exposures and EDIS are linked, it is possible to introduce this dimension within EDIS rather than banking regulation. This would mean taking domestic exposure to sovereign-bonds into account when establishing the formula for bank contributions to EDIS, which would obviate the need to change the entire regulatory framework. There would be no mismatch between European rules and the Basel rules, which could be potentially damaging to European banks. However, the European Commission has not yet taken a position on this proposal.

Conclusion

A Central Bank official highlighted the one strong point of consensus in the discussion: the need for fiscal discipline. Beyond this, there is considerable variation between panellists' views. There are mixed views on regulatory or prudential treatment, but the majority do not consider it to be the best option available. The representatives of the market suggest that the focus should be on Pillar 2 or Pillar 3 measures. This could help move the debate forward. Additionally, the Central Bank official outlined the troisième voie of including risk indicators related to sovereigns in EDIS. Additionally, there should be a full debate on the important issue of safe assets.