SOVEREIGN / FINANCIAL SECTOR / CENTRAL BANK LOOP

1. The sovereign bank nexus still needs to be addressed 11 years after the global financial crisis

The Chair explained that the topic is not something new and the question is whether the topic is still relevant. The sovereign debt crisis demonstrated bank risk and sovereign risk are closely intertwined. The entire 30 year German public sector yield curve is currently in the negative. Bank exposures to sovereigns are still on average around three quarters of Tier 1 bank capital, and could still wipe out almost all bank capital should there be a problem.

2. The evolution of the sovereign-financial sector loop

2.1. The sovereign bank loop is a reality across geographies

An industry representative explained that the negative financial sector sovereign feedback loop is a structural reality around the globe, which reflects both the direct exposure of banks to what is sovereign, but also indirect exposure. When considering the weight of sovereign and banks in the economy, it is natural to see the risk of a feedback loop.

From the global rating universe, it is extremely rare for banks to be rated above their sovereign. A quasi-totality of banks around the globe would be at risk of default if their sovereign defaults, which reflects not only direct exposure but the credit risk in the economy, the funding liquidity, convertibility risks, reputation and confidence. Across countries the level of direct exposure is significant.

Across countries the level of direct exposure is significant. Quite often it is above 100% of common equity Tier 1 capital, and in multiple countries over 200%. Examples include China, Japan, France, Spain, Portugal and Italy. The list of these significant exposures is quite long, and there has been no material change in that exposure. In a few instances, there has been a decline, for example where countries have very negative yields or declining sovereign debts, but it has become a structural feature.

2.2. The risk of an adverse feedback loop is not the same among jurisdictions

A Central Bank official noted that Japan and high debt countries in Europe share a high level of government debt to GDP ratio, and banks and central banks hold a large quantity of government bonds. However, there are significant differences that can lead to a difference in the risk of an adverse feedback loop.

One difference concerns fiscal discipline. Some European countries increasingly face popular pressure to increase public spending, but in Japan the government continues to express the will to maintain fiscal discipline. Another difference is denomination risk. In some European countries, an increase in fiscal deficits led to the risk of an exit from the Eurozone and the resultant rise in long-term interest rates, whereas Japan does not have such risks.

The adverse feedback loop will not materialise in the foreseeable future in Japan, but there seems to be some worry about the possible emergence of it in Europe.

2.3. Some positive recent improvements in addressing the sovereign financial sector feedback loop

An industry representative indicated that there have been some positive developments with regard to the feedback loop risk. For Europe, there are improvements in banking system credit worthiness across multiple countries, which have had a positive impact on sovereign ratings. The build-up of bail-in-able buffers of minimum requirements for own funds and eligible liabilities (MREL) and total loss-absorbing capacity (TLAC) has reduced the contagion liability of sovereigns vis-à-vis the banking system, even if it is not believed that the resolution regimes will work in all scenarios.

Another factor is the improvement in sovereign ratings. Europe has had the highest proportion of sovereign rating upgrades and the vast majority of European sovereigns have stable or positive outlooks. The European resolution regimes and the build-up of bail-in-able buffers can also, to some extent, reduce senior unsecured creditors of systemically important banks and increase resilience to potential sovereign shocks.

The reasons there are not more examples currently are that many European sovereigns are strong and, more importantly, the build-up of bail-in-able buffers is still work in progress. With the resolution framework in Europe, in particular the Single Resolution Board (SRB) and the Single Resolution Fund (SRF), it is believed that the conditions to step in and protect senior unsecured creditors are difficult and surrounded by multiple uncertainties, which means not being able to ex ante the fact of a potential support for senior unsecured from the SRB.

2.4. Banks are more resilient but the home bias in sovereign bond holdings continues to be strong

A regulator confirmed that, thanks to the efforts of all stakeholders, there has been much progress regarding the stability of the EU financial system. By implementing the Banking Union, there are higher capital ratios in the banks and the volume of non-performing loans (NPLs) has reduced. MREL and bail-in rules have been implemented. There is also supervisory convergence throughout the banking union.

However, home bias remains a strong element of sovereign exposure. Indeed concentration risks in sovereign exposures remains a critical link in the sovereign-bank nexus. The home bias ranges from less than 3% to up to 91% of domestic sovereign bonds held by domestic banks. This is a main reason for why there is not a common understanding regarding the application of the resolution framework, especially when it comes to the public interest test.

The Chair asked an audience question regarding whether the EU has really committed to bank resolution. An industry representative replied that resolution is one tool. In the past there was a lack of potential systemic implications of some banks' defaults. There have been pragmatic approaches, which have avoided implementing the resolution as it was designed. A major obstacle to implementing the resolution is the build-up of bail-in buffers. When the problem becomes more systemic, resolution will not be a magic solution.

3. The way forward: different points of view but fiscal discipline and sound macroeconomic policies are essential

The regulatory treatment of sovereign exposures is a long-standing problem. With global efforts for an international standard stalling, Europe should start setting the right prudential incentives, develop an approach that is both effective and feasible and complete the Banking Union. A public decision maker stressed that each jurisdiction needs to judge whether it should introduce any measures that target sovereign exposure by banks while considering the risk of an adverse feedback loop and the economic and monetary situation within each jurisdiction. Fiscal discipline is vital notably to address the root cause of sovereign problems.

3.1. A longstanding problem

3.1.1. The regulatory treatment of sovereign exposures is not a new issue

An industry representative explained that 30 years ago, one of the issues the Basel Committee discussed, (in the aftermath of Basel I), was the treatment of sovereign exposures. The question at the time focused on how broad the zero-risk weight should be.

Ideas and proposals have been published that outline technical aspects for dealing with the sovereign-bank nexus. For example, the Basel Committee completed an exhaustive review and think tanks suggested how to calibrate concentrations to disincentivise the holding large sovereign exposures.

3.1.2. What is missing right now is urgency

The same industry representative noted that progress happens when there is urgency. Urgency often occurs when actors are under pressure. Currently, sovereigns are able to finance themselves at very attractive rates (i.e., low or negative rates), and banks are able to fund themselves because the financial system is awash with reserves. The traditional catalyst for action is missing, but this is a window of relative calm where there is an opportunity to do something. Policymakers should take advantage of this window.

3.1.3. The current negative yield environment may not persist. Policymakers should take advantage of it

There is $15-16 trillions' worth of government debt sporting negative yields. The four European peripheral countries that were in crisis just a few years ago – Greece, Portugal, Spain and Italy – all have 10 year yields that are below the US 10 year yield. The question is whether the environment of negative interest rates and low interest rates will persist, and for how long. There should be readiness for a sudden shift back. If and when that shift does come, it is very likely to be rapid and disruptive, and there is likely to be a lurch upwards in interest rates. If this issue has not been dealt with, the sovereign bank nexus will arise in a very uncomfortable setting. The time to address the regulatory treatment of sovereign exposures is now.

3.2. A roadmap for completing the Banking Union

A regulator explained that to further reduce the link, there should be a move towards EDIS, but also steps towards a reasonable treatment of the sovereign exposures. This is highly political and controversial; therefore, a step-by-step approach is needed. Furthermore, according to this regulator, without EDIS and a reduction in the home bias, the Banking Union will not be complete. Only with these two cornerstones in place can the Banking Union 's initial mandate – untangling states and banks-be achieved.

3.3. Setting the right regulatory incentives in the Banking Union area

A first step could be to set incentives to reduce the home bias of sovereign risk in the bank's balance sheets and make them more European rather than national. Fewer home buyers and more European focus in the sovereign bond holdings is key. If the European banks were more European in their sovereign exposures, the effects of a sovereign bank crisis could be managed more effectively. The European way was chosen by the legislators when they decided to have a banking union with a Single Supervisory Mechanism (SSM) and the SRB.

Euro area banks should be incentivised to hold a well-diversified euro area sovereign portfolio. Rather than penalise the holding of sovereign debt, risk reduction through sufficient risk diversification should be incentivised. With such an incentive, zero risk weights could only be granted to well diversified sovereign portfolios. Overly concentrated portfolios would then be subject to own fund requirements for disproportionate exposures to any euro area member state.

The benchmark portfolio could be composed along the lines of the GDP shares of the eurozone countries. The share of Euro members in the Eurosystem could also be used.

Calculations for a representative and large part of SSM significant institutions, based on the assumption that the current sovereign bond portfolios remain unchanged – the banks hold roughly 2280 bn Euro area sovereign exposures -, and a risk weight of 20% for sovereign debt assumed, shows that the average impact would be moderate. The risk weighted assets would increase by 4.1% on average, and the CT1 would decrease by 57 basis points on average per bank.

For the average CET1 effect by member states, the impact would range from 38 basis points to 250 basis points in the large countries of the eurozone, and the effect throughout below 75 basis points. For the CT effect bank by bank, about 15% of outliers suffer a large impact because of their specialized business model. About 70% of the banks are affected by a decrease of less than 100 basis points.

However, given the incentive, the expectation is that banks will significantly diversify their portfolios and therefore be subject to substantially lower capital impacts. By diversifying their portfolios they can even avoid additional capital requirements. Other proposals and discussions regarding the treatment of sovereign bonds are focused on limiting overall levels of sovereign exposures.

This proposal would be for the eurozone, not the EU27 and not globally, due to the existence of the Banking Union.

The Chair asked an audience question relating to whether it is politically acceptable to explain to somebody who wants, for example, a Finnish mortgage that they must pay more because of investment in Italian sovereign bonds.

A regulator agrees that it is a highly political question. There is a significant home bias in the bank balance sheets and there has been discussion for 30 years about the risk weight for sovereign debt. There are other proposals in the same direction regarding the risk diversification as the first step.

An industry representative added that asking a bank in a country with high funding costs to pledge and put a large part of its liquid assets in government debt, and knowing that one main concern is profitability, could have other unintended consequences for the system. More systematic disclosures about the exposure might help to push the banks to adapt.

An industry representative believed that the suggestion is a pragmatic way forward, at least to begin the discussion. There has been progress in Europe on resolution. The establishment of the SRB is a significant step forward, as is the SSM.

3.4. Each jurisdiction needs to judge whether it should introduce any measures that target sovereign exposure by banks while taking into account the risk of an adverse feedback loop and the economic and monetary situation within each jurisdiction

A Central Bank official explained that everybody agrees on the importance of containing the emergence of an adverse feedback loop between sovereign and financial institutions. To address the sovereign-bank nexus from the perspective of policymakers, each jurisdiction needs to judge whether it should introduce any measures that target sovereign exposure by banks.

3.5. Sound macro economy policy is the appropriate solution

If there is a panacea for addressing the risk of the sovereign-bank nexus, it is sound macroeconomic policy, which no regulation can substitute for. However, it is also practically desirable that each jurisdiction should take into account the risk of the adverse feedback loop to assess the necessity of introducing regulatory treatment of sovereign exposure by banks. For Japan, it is not necessary to introduce any such regulation.

3.6. A sovereign default is possible

A participant suggested that while a pragmatic and step-by-step approach may be essential, one piece that is missing is the question of an insolvency law or regime for the states. If there was a real risk of a state going bankrupt, then risk managers would immediately say there needs to be capital for that risk. However, if there is no such risk then it does not make sense to have such a capital requirement.

The Chair asked whether a sovereign default is possible. An industry representative noted that even in Europe investors in sovereign debt have had some losses. The track record across the world demonstrates a large number of investors having losses on sovereign. It is unclear whether that would drive a change in capital. The banks, in their internal capital models, are also locating funds in front of sovereigns.

An industry representative added that Argentina occasionally acts as a reminder that countries can go bankrupt, default or restructure. Greece was a default of sorts because the maturity was re-profiled, so it even occurs within the eurozone.

The Chair noted that there is also the issue of whether every sovereign qualifies for a zero-capital weight, which is a different argument about whether they are all the same in terms of risk.