Sovereign exposures and low interest rates

Rolf Strauch

Chief Economist and Management Board Member, European Stability Mechanism (ESM)

Fiscal rules and market discipline – complementing each other

The EU fiscal framework provides a line of defence against fiscal profligacy. The rules aim to limit fiscal deficits and prevent excessive government debt that risk destabilising the monetary union. Since the creation of the Stability and Growth Pact, economic and financial conditions have evolved considerably. The rules have been fine-tuned and have become more complex. Now there is an opportunity to review them. The European Commission has launched a public consultation to collect feedback and ideas.

Market discipline can help limit unsustainable public finances, but failed to do so in the run-up to the sovereign debt crisis. Before 2008, sovereign credit risk was not priced in appropriately, as government bond spreads were compressed. Markets believed that the fiscal rules would ensure sustainability or countries in distress would be bailed out. The mispricing of risk was one of the deficiencies dis-incentivising adequate fiscal policies.

In times of stress, markets can swing into the other extreme and spreads can widen abruptly. Even if market volatility is not due to fundamentals, it can have negative effects on a sovereign and aggravate a crisis. Erratic and irrational moves, particularly when driven by herding behaviour, can lead to market failure. Additionally, perceptions of redenomination risk can exacerbate contagion in the euro area. A constellation of different mechanisms can lead to pro-cyclical price spirals and market closure in crisis times. Liquidity may evaporate quickly in a sovereign bond market and this may lead to liquidity shortages across markets.

We should foster complementarities between fiscal rules and market discipline. On the one hand, market reactions can contribute to fiscal discipline because market developments inform policymakers about the consequences of their decisions. On the other hand, a rule-based fiscal framework can tame market capriciousness by managing expectations. An effective framework should encourage proper risk pricing by markets.

Fiscal rules can serve as a sign-post for markets, and flag risks to investors. More predictable and transparent rules can help the appropriate pricing of sovereign risk and temper the binary perceptions of "risk-on" vs "risk-off" mood or risky versus safe assets. Investors can anticipate and internalise ("price in") the policy reaction when rules are transparent and credible, even without disciplinary action. This works the better the more transparent and consistent rules are, and the more credible the enforcement.

More well-behaved and risk-guided markets support policy responsiveness to markets. Policy adjustment often comes too late when market moves are extreme. Signals may be there earlier, but are often blurred and the bar for policymakers to react can be high. In other words, policymakers are better informed about market signals and their implications with more predictable and credible rules giving clearer signals to investors. This creates better conditions for adequate policy responsiveness to fiscal vulnerabilities and less pro-cyclical fiscal policy.

The ongoing review provides an opportunity to improve fiscal rules. For instance, gearing rules towards observable variables can improve the clarity of the guidance both for policymakers and for markets. It also increases transparency. A number of institutions propose an expenditure rule to set operational targets, combined with a debt rule, as a fiscal anchor. This could be a way forward to explore further.

At the same time, other steps are needed to deepen Economic and Monetary Union (EMU) and increase its robustness to shocks. The completion of banking union and more capital market integration would support private sector risk-sharing. A central fiscal capacity and a European safe asset would support financial stability in the euro area and also the international role of the euro. ●

Eduard Müller

Executive Director, Austrian Financial Market Authority

"Gone concern" or "concerns gone" in the sovereign-bank-insurance loop?

Usually, there is no safer asset than government debt, hence why banks and insurance firms are among its top investors and holders. This creates a reciprocal dependency between governments and the financial sector. But where do we stand now, ten years after the Euro Area sovereign debt crisis?

Government debt stock in bank and insurance books has not decreased much since 2010, but progress has undoubtedly been made. Banks and insurance firms today have bigger capital and liquidity cushions. Tougher regulation and supervision of non-performing loans have led to a visible risk reduction, until recently somewhat aided by benign economic conditions. Importantly, the leverage ratio, implemented in the EU by the CRRII, represents an explicit own funds requirement for all assets, without risk-weights. Thus, from 2021, sovereign exposures will be encompassed by the leverage ratio own funds requirement, with banks holding larger stocks ▶

having to hold more capital. Furthermore, high concentrations of sovereign exposures on bank balance sheets undergo supervisory scrutiny during the annual SREP exercise, which feeds into the Pillar II requirement. Finally, with the Banking Union, we now have a deeply integrated supervisory and resolution system in the Euro Area, with only a common deposit insurance system missing. The European Stability Mechanism (ESM) will undoubtedly soon provide an important backup for the Single Resolution Fund and enhance the credibility of a resolution of a systemically important bank.

All measures considered together, and in light of their being fully implemented, is concern about an unaccounted sovereign risk still justified? Further analysis and data collection by EBA and ECB may allow conclusions to finally be drawn whether and what further regulatory treatment of sovereign exposures might be warranted. The fundamental question of whether a gone concern or going concern perspective is taken will shape the answer. Under a gone concern perspective, wouldn't we seek insurance against our own potential failure? By basing our regulatory framework on a going concern perspective for the Euro Area, we may be closer to a reasonable framework for treating sovereign exposures than we think.

Dis-incentivising very high concentrations and strong home bias in sovereign exposures remains an issue to address. In the short-term we could increase regulatory and supervisory scrutiny of concentration risks in Pillar II. In the medium and long-term, a Pillar I concentration risk charge to further foster diversification of sovereign portfolios should be sought at international level, while pursuing the idea of sovereign-bond backed securities, providing a much needed well-diversified safe asset to European banks and asset managers. We have achieved much, and have gone far in implementing the Banking Union, which will help tremendously to weather the current COVID-19 crisis. The Banking Union should be now completed in small, mutually reinforcing steps, based on risk-sharing and discipline.

We may be closer to a reasonable framework for treating sovereign exposures than we think.

Supervisors must play an important role and should support this by providing data and analysis and ensuring a reasonable and transparent treatment of sovereign concentrations in the SREP process and Pillar II requirements. ●

Pedro Marques

MEP, Committee on Economic and Monetary Affairs, European Parliament

Complete the Banking Union to address the sovereign-bank nexus

It is a given that economies face risks and sometimes those risks materialize into an effective crisis. Either the economic crisis is originated in the financial sector, as it happened a dozen years ago, or it begins with a public health crisis, as we are experiencing now, the fact is that sooner or later a new crisis occurs.

This does not mean that crises are acts of God, something completely beyond our control and that there is nothing we can do. In fact, there is much we can do, as the timing, size and consequences of each crisis may depend on the way we manage and mitigate risks *ex-ante*.

In the financial sector, one of the risks considered among the most serious is the nexus between sovereign and banks risks, known as the "doom loop".

No matter if the original shock is initiated in the banking sector (forcing the government to issue debt to recapitalize banks) or in the sovereign market (when perceived risks of sovereign bond generates potential bank losses), the feedback relation will amplify the magnitude of the crisis in both, with spillover effects over the economy and the consequent loss of jobs and other major social consequences.

The tools to address sovereign-bank nexus are comprised in the Banking Union's architecture.

Lessons learned from the financial crisis gave an impetus to the creation of the Banking Union (BU), aimed at reducing the banking sector's risks and creating a level playing field across the euro area. The BU, however, remains incomplete.

Although the effective implementation of its' first pillar, the Single Supervisory Mechanism, along with significant efforts from the Member States resulted in a sharp decrease of risks in the banking sector (e.g., the euro area NPL average came down from 6,5% in December 2014 to 2,9% in September 2019), the EU's ▶

inability to complete the BU has one consequence: risks are still out there.

In terms of the BU's second pillar, there are justified concerns that the Single Resolution Fund (SRF) does not have the necessary means to address the resolution of one or more big banks, so it is necessary to create a backstop for it, which should probably be the European Stability Mechanism. An SRF with the necessary firepower is one of the most important tools to placate the loop between banks and sovereigns, but the lack of agreement in the Council is stalling the decisions.

Finally, the third pillar, the European Deposit Insurance Scheme (EDIS), is simply missing. The creation of the EDIS would assure that all depositors receive the amounts guaranteed by the European Directive with no need to use taxpayers' money (and without affecting the sovereign).

It is not necessary to reinvent the wheel. The most effective tools to address sovereign-bank nexus are already defined: they are included in the BU's architecture and just have to be completely implemented. If we can complete the BU and work towards the creation of a European safe asset, to allow banks to reduce their balance sheets' exposure to sovereign debt, there simply won´t be any doom loop anymore. ●

Andreas Dombret

Global Senior Advisor, Oliver Wyman

A European Safe Asset: don't put one step before the other

The sovereign-bank nexus has been at the core of nearly all economic and financial crises in modern times[1]. The same households and businesses that borrow from banks are paying taxes to finance the state. Banks hold sovereign paper for liquidity and investment purposes, and in smaller countries play an important role in keeping public debt markets liquid. It will therefore never be possible to "solve" the nexus by eliminating it. However, it can be damped.

Capital requirements and loss absorbency (MREL) for banks have increased markedly, and with the BBRD a comprehensive resolution toolset has been created. With the Single Resolution Board and Fund, now backstopped by the ESM, the necessary institutional landscape has been established, also allowing Euro countries to combine their firepower.

Still not solved is the effect distressed sovereigns have on their banks, which could suffer losses on public debt they hold, and whose funding costs depend on "their" sovereign. Safe or "risk-free" assets are underpinning many financial products, liquidity rules require banks to hold HQLA, which they often do with a "home bias". Despite sovereign yields across the Eurozone having converged also as result of ECB's purchasing programs, lower-rated sovereign debt remains a welcome profit source in today's "low for long" environment.

The fragmentation of the Euro system's sovereign debt market adds to other hurdles for banks' cross-border business models, for example limiting the use of Dutch deposits to fund Italian loans. Further consolidation in the banking union requires diversification. For sovereign holdings, concentration risk must be reduced, similar to long-standing practice for large exposures to private sector creditors. Differentiated risk-weights and concentration limits on sovereign exposures are thus needed to prevent banks from overexposing themselves to a particular country.

> *Banks, the economy and the sovereign will always remain linked to each other.*

In this context, a European Safe Asset ("ESA") has been suggested as a theoretical concept to further complete the currency union. Under the proposed approach of "ESBies"[2], investors indirectly hold a diversified basket of member state debt. However attractive, important side effects need to be considered. The volume of ESA issuance will be determined by market demand, potentially resulting in higher-grade debt such as Bunds being absorbed through ESAs, while more risky paper remained standalone and exposed even more. While ESAs could well weather idiosyncrasies in a smaller member state, a synchronized downturn or stress in a larger member state would cause ESAs threatening to destabilize the entire Eurozone, then requiring broad, untargeted monetary or fiscal support measures. This resulted in risk sharing among member states currently not foreseen in the EU Treaty. Also, market prices would be distorted and lose their signalling capability if a very large investor buys sovereign paper at a political price.

Key question is how large the ESA market will be compared to overall Euro member state public debt issuance. A smaller volume brings a welcome increase of the safe asset pool and HQLA[3]. With an increasing volume however, effective characteristics of ESAs get closer to those of "Eurobonds". A robust fiscal coordination mechanism, such as the Stability and Growth Pact, remain required in any case together with meaningful monitoring framework. A reinforced ESM would go into the right direction. Other considerations, like providing more fiscal flexibility at member state level, do not. Today, we should be aware of the risks of putting one step before the other. Policy makers should keep this in mind in waging the options of further strengthening the banking and currency union. ●

1. Laeven / Valencia (2018): Systemic Banking Crises Revisited.
2. Brunnermeier et al. (2016): ESBies: Safety in tranches
3. Grandia et al. (2019): Availability of high-quality liquid assets and monetary policy operations: an analysis for the euro area, ECB Occasional Paper Series.

Alexandre Birry

Global Head of Research - Financial Institutions, S&P Global Ratings

Banking-as-we-know-it won't prevail if long-lasting negative rates do

The current coronavirus pandemic poses much greater immediate challenges to financial stability than ultra-low or negative rates. The wide-ranging package of monetary policy measures implemented--which ultra-low rates are only part of--will hopefully help tackle some of the more imminent threats. But it remains true that, if prolonged, ultra-low rates can affect financial stability. In a European context, once the situation normalizes, durably low rates could upend the financial intermediation model. The role of banks would change as a result, and so would that of capital markets and supervisors. Ultra-low rates and flat yield curves question banks' traditional -and oft fundamental- maturity transformation profitability model.

Borrowing short-term to lend long-term doesn't pay for itself the way it used to. Assuming this monetary backdrop is here to stay, banks will have to continue to adjust their business models. One likely consequence is that banks will generally need more scale. Not just in terms of size, but also breadth of activities. This would allow banks to reduce their dependence on balance sheet intensive products such as deposits and loans.

Instead, they may develop alternatives such as asset management or other forms of off-balance sheet financial intermediation, putting stakeholders with excess savings in direct contact with stakeholders in need of funding for instance. In the context of durably slower economic growth, economies of scale are likely to remain key to banks' business model sustainability, as further cost discipline is required to buffer pressured earnings and meet shareholders' expectations.

Scale will also allow banks to invest in the technology required to meet customers' evolving expectations. What does it mean in terms of financial stability? One consequence of greater scale and consolidation is the possible emergence of even more systemic institutions. As banks become larger and more diversified to adapt to the environment, their complexity and respective importance to the local economy increase.

Against this backdrop, further progress with bank resolution--which is still very much work-in-progress-will be key to avoiding a worsening of the sovereign-bank feedback loop. Another consequence is the need for effective European capital markets, if banks' role is increasingly to facilitate direct financial intermediation. The success of the Capital Markets Union (CMU) project will therefore be critical. In addition to alternative revenue streams, CMU (including deeper securitisation markets) also offers opportunities for banks to manage their capital and credit risk more effectively. Also, lower-for-longer interest rates could reinforce the reliance of the European economy on debt. The strong preference of European corporates for loan and debt financing instead of equity financing is likely to continue unless the CMU becomes reality.

A third, related, consequence could be the acceptance that banks' role in mutualizing credit and market risks will be diminished to the extent that non-bank private sector stakeholders (eg. pension funds, insurance company, households) increasingly assume these risks directly. This would ultimately reshape the distribution of losses during crises.

> *Low-for-long can help fund transitions that are critical to the long-term stability of the financial system in Europe.*

As a result, supervisors' role as well will likely continue to evolve. As part of the risks of the financial system migrate outside the banking system, the remit of supervisors broadens. This comes on top of the need for greater use of macro-prudential tools as durably low rates typically inflate asset prices and risk appetite in the absence of a crisis.

That said, low-for-long can help fund transitions that are critical to the long-term stability of the financial system in Europe; first, the transition to greater resolvability, by allowing banks to issue at low cost substantial amounts of loss-absorbing instruments and meet TLAC and MREL requirements. Second, substantial amounts of funding are required to finance the energy transition to mitigate climate risk. Low-for-long can make this transition more affordable, and offers banks some much-needed growth relays in an otherwise low-growth environment. ●