Euro50 Group

The Future of European Government Bonds Markets

Banks' Sovereign Exposures and the Feedback Loop Between Banks and Their Sovereigns

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An intensely debated topic in the context of possible further financial reforms, in Europe and internationally, concerns possible actions to address the negative loop between sovereign risk and bank risk. The sovereign-bank nexus was one of the main amplifying factors of financial distress during the euro area crisis. Banks' difficulties affected sovereigns directly, through the bailout of troubled intermediaries, and indirectly, through the impact of the disruption of lending on the economy. Sovereigns' difficulties affected banks' ratings, funding costs, and balance sheets, while the recession worsened their lending portfolios.

Before the euro-area sovereign debt crisis, sovereign defaults were regarded as a problem of emerging economies. Indeed, no advanced (OECD) country defaulted on its domestic debt between 1950 and 2010.[1] Therefore, it is not surprising that virtually all national supervisory authorities have exercised the regulatory option to exempt banks' exposures to their domestic sovereign, denominated and funded in domestic currency, from the standard prudential banking regulation. These exposures are *de facto* subject to no concentration limits and to a zero risk weight regime.

Following the recent euro-area sovereign debt and banking crises, it has been argued that this preferential prudential treatment should be amended. Interestingly, this debate is not new. Initially it took place in the early eighties, when Basel I was crafted. Reaching a consensus on the framework was difficult. Two proposals were eventually tabled, recommending a 20 percent risk-weight on domestic sovereign exposures, and a zero-risk weight, respectively. Eventually the solution to apply a zero-risk weight was chosen, apparently without any empirical analysis.[2] A key role in the choice was played by the recognition of the crucial role of sovereign bonds and securities in the functioning of financial markets, with the aim of fostering the development of local bond markets, and the desire to avoid interference with fiscal policy and monetary policy.

[1] Reinhart, C.M. and K.S. Rogoff (2011), "The Forgotten History of Domestic Debt", *Economic Journal*, 121(552).

[2] Goodhart, C. (2011), *The Basel Committee on Banking Supervision. A History of the Early Years 1974-1997*, Cambridge University Press.

In the current debate, possible options range from the "baseline option", i.e. keeping the current framework unchanged for exposures to the domestic sovereign, to assigning these exposures a non-zero risk weight and/or subjecting them to concentration limits.[3]

Those who advocate changing the current framework argue that assigning banks' sovereign exposures a non-zero risk weight increases capital and thus the resilience of the banking system. Similarly, introducing rules to discourage a high concentration of sovereign exposures would increase banks' chances of surviving a sovereign default, preventing them from playing a "shock amplifier" role, as in recent cases of distress of sovereigns with weak economic fundamentals.[4] Furthermore, if risk weights accurately reflect sovereign risk, they can incentivise banks' risk management of sovereign exposure by recognising that the higher return from riskier counterparties comes at a cost of increased incurred risk. Also, in case a crowding out of private lending by public debt exists, a risk sensitive approach for sovereign risk could reduce this effect and promote the more efficient allocation of resources, leading to higher investment and higher potential GDP growth.

Advocates of the "baseline option" also advance several arguments.

First, this option does not really mean "no change", as recent amendments of the regulatory and legal framework have already made substantial progress towards breaking the bank-sovereign loop. In Europe, the banks-to-sovereign causal link has been addressed by bank-related reforms, beginning with the BRRD. On the prudential front, banks' sovereign exposures are taken into consideration in the capital exercise and stress test frameworks applied since the end of 2011[5] – the results of which are nowadays taken into account in the Pillar 2 capital buffers required within the SREP – and through the forthcoming introduction of the leverage ratio. Furthermore, the European fiscal framework has been enhanced across several dimensions, thus addressing the sovereign-to-bank nexus: the Stability and Growth Pact has been amended, reinforcing both its preventive and its corrective arm; member countries have strengthened their national budgetary

3 J. Weidmann, "Stop Encouraging Banks to Load up on State Debt", *Financial Times*, 1 October 2013; European Systemic Risk Board (2015), *Report on the Regulatory Treatment of Sovereign Exposures;* Dutch Presidency note on *Strengthening the banking union and the regulatory treatment of banks' sovereign exposures*, prepared for the informal ECOFIN meeting of 22 April 2016.

4 Battistini, N., M. Pagano and S. Simonelli (2014), "Systemic Risk, Sovereign Yields and Bank Exposures in the Euro Crisis", *Economic Policy*, 29 (78).

5 To be precise, in the EU the capital exercise in 2011 and the subsequent stress tests have amounted to the introduction of a capital charge on sovereign exposures. In spite of this, exposures continued to increase until the sovereign crisis subsided, in 2014.

processes and institutions; and a surveillance mechanism has been set up for early detection and correction of macroeconomic imbalances. Finally, the European Stability Mechanism was established.

Second, tightening regulatory standards on sovereign exposures can hardly be sufficient to safeguard banks against their domestic sovereign default. Direct exposures are just one of the channels that transmit sovereign risk to the domestic banking system. Sovereign defaults are associated with severe economic crises, which have a widespread negative impact on domestic banks quite independently from the degree of their direct exposure.[6]

Third, preventing an excessive concentration of risks may be desirable in principle. However, the historical experience shows that in a "normal" economic environment EU banks autonomously reduced their sovereign portfolios (as well as the concentration) without any need for regulatory nudges (Fig. 1). Indeed, the evidence suggests that most EU countries' sovereign holdings behaved counter-cyclically: they declined during the "normal period" between the introduction of the euro and the beginning of the financial crisis; increased during the crisis period; and started once more to decline in the last two years, as the crisis began to subside (see the cases of Italy - Fig. 2 - and Spain).[7] This pattern suggests that regulation is not an important driver of banks' exposures towards their own sovereign: throughout this entire period, the prudential treatment of sovereign exposures remained broadly unchanged. It also indicates that high sovereign exposures are a symptom and a consequence, rather than a driver, of the crisis.[8]

Fourth, whereas in "normal" times banks' sovereign exposures declined spontaneously, the imposition of risk weights or – worse – tight concentration limits could create substantive difficulties in "crisis" times. They could be particularly disruptive for banks' ability to act as shock absorbers in the event of sovereign stress. There is evidence that sovereign debt markets are prone to self-fulfilling crises: if investors believe a sovereign faces fiscal problems, required

[6] Committee on the Global Financial System (2011), "The Impact of Sovereign Credit Risk on Bank Funding Conditions", BIS, CGFS Papers, No. 43.

[7] Lanotte, M., G. Manzelli, A.M. Rinaldi, M. Taboga and P. Tommasino (2016), "Easier Said than Done? Reforming the Prudential Treatment of Banks' Sovereign Exposures", Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 326.

[8] Angelini P., G. Grande and F. Panetta (2014), "The Negative Feedback Loop Between Banks and Sovereigns", Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 213.

yields will be higher, which can exacerbate, or even create, the fiscal problems.[9] Probably the clearest recent example of this pattern is the surge in "redenomination risk" in the euro area, connected with undue fears of a break-up of the Monetary Union. To the extent that banks act as contrarian investors (selling assets when markets overheat and buying when they are excessively bearish), purchases of sovereign debt when the sovereign experiences difficulties notwithstanding relatively solid economic fundamentals are actually beneficial to financial stability. There is clear evidence that domestic investors played such contrarian role during the EU sovereign debt crisis, buying sovereign bonds as foreign investors were fleeing (Fig. 2 again for the Italian case; similar patterns have been documented for Spain).[10]

Imposing risk weights or setting large exposure limits on domestic sovereign exposures would impair this shock-absorption ability. Exposure limits, in particular, could act as a coordinating device for speculative attacks. Since a change in banking regulation would likely herald a similar change in other parts of the financial system (most notably the insurance sector), the entire domestic financial sector could be affected.

Finally, a system which differentiates the risk weights according to the sovereign's credit risk could end up relying upon ratings issued by the Credit Rating Agencies (CRA). Even advocates of a change in the prudential treatment of sovereign exposures admit that credit ratings of sovereigns have serious shortcomings. In particular, they tend to be backward-looking and to foster herd behaviour. As such, they could exacerbate pro-cyclicality and ultimately increase financial instability risk.

Overall, I believe that today, as 30 years ago, the mere recognition that there is no truly risk-free asset does not per se warrant a change in the regulatory treatment of sovereign exposures. I doubt that further changes in prudential regulation are the right instrument for addressing the sovereign-bank nexus, taking into account that sovereign risk should first and foremost be addressed by strengthening the sustainability of public finances. In this regard, while member states should attain sound fiscal positions so as to make their sovereign paper safer, enhancing economic growth represents the most important factor for putting the public finances on a sustainable path.

9 De Grauwe, P. and Y. Ji (2013), "Self-fulfilling Crises in the Eurozone: An Empirical Test", *Journal of International Money and Finance*, 34(C).

10 The reason why such a shock absorption role can be beneficial is not because it "enables sovereigns to expand the budgetary stance", as stated in the Dutch Presidency note cited in footnote 3, but because markets can be subject to excessive movements.

This is clearly shown by the example of Italy, where the debt to GDP ratio has risen by 33 percentage points since 2007. Back-of-the-envelope calculations show that if Italian real GDP had since grown at a similar rate as in the previous ten years and the deflator had risen in line with the euro area's inflation target, the debt to GDP ratio would now be just 3 points, and not 33 points, higher than in 2007 (actually, it would be slightly below the 2007 level, once the financial support to other European countries is taken into account).[11] This suggests that efforts to rebalance the public finances must be part and parcel of an economic policy designed to create the conditions for robust and lasting growth.

I also believe that any reform proposal should be based on a comprehensive approach, avoiding partial equilibrium analyses and capturing all the relevant effects; also, it should be evaluated by focusing on potential benefits and costs in a financial stability perspective, taking into account potential unintended consequences. Considering the pervasive role played by sovereign bonds in modern economies, these can arise in various sectors, well beyond banking.

To this end, a deep understanding is needed of: the extension and potential effect of any reallocation of bank sovereign exposures across banks; the interactions with other rules of the Basel framework, including in particular the rules on liquidity; the impact of changes in regulation on the provision of loans to the broader economy; the consequences for monetary policy; the effects on the functioning of sovereign debt markets and on governments' financing conditions; the impact on other financial market segments.

Several of these issues are being investigated at the BIS and also at the EU level, within the European Systemic Risk Board and the Economic and Financial Committee. The impact on market liquidity has been examined in this conference. Changes in the current prudential framework leading to stricter capital requirements on sovereign bonds could incentivise banks to further reduce the two pillars of market-making: sovereign bond inventories and repo activities, which are eroding liquidity in secondary markets.

The effects of a regulatory change requiring substantive bank recapitalisations could be destabilising in the transition phase, as it would entail a temporary but negative impact on credit to the economy – an important effect, in the presence of stubbornly low nominal growth and deflation risk. Such an effect is hard to capture analytically, as non-linearities are possible,

[11] "Preliminary testimony on the 2016 Economic and Financial Document", testimony of the Deputy Governor of the Bank of Italy, L. F. Signorini, Chamber of Deputies, Rome, 18 April 2016.

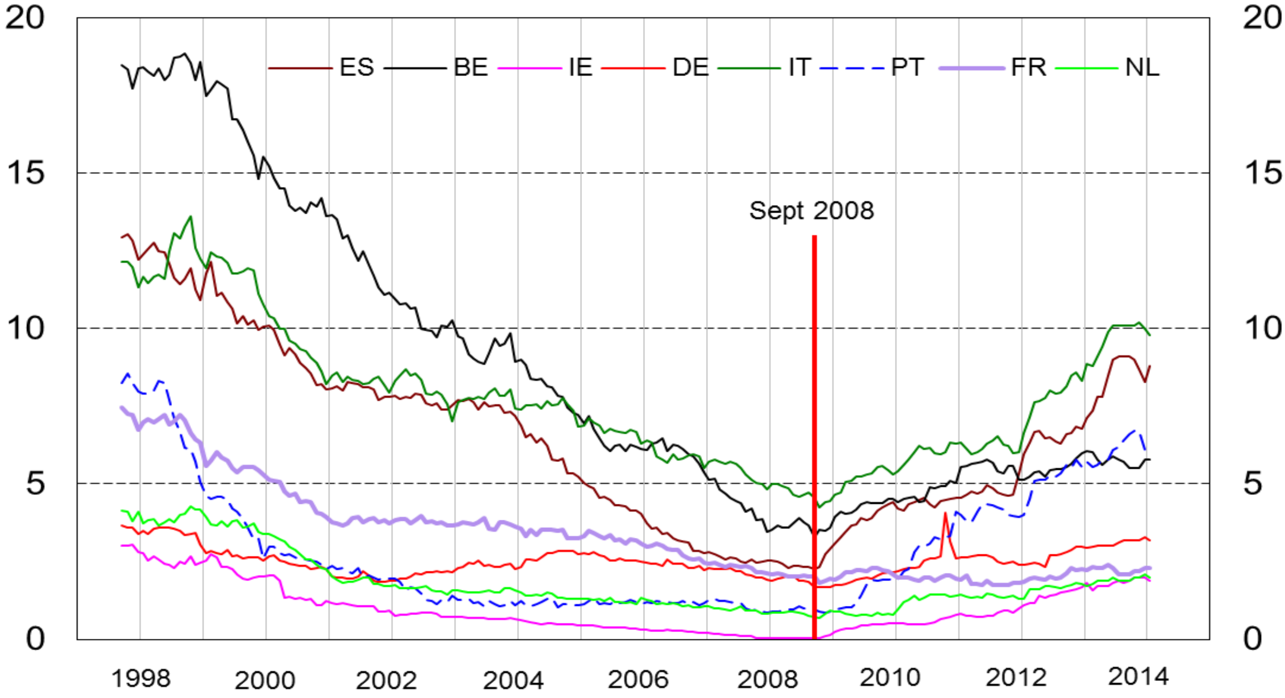
especially in the presence of financial tensions, and multiple equilibria cannot be excluded. Envisaging a long transition period is unlikely to help, as market participants will probably respond immediately by front-loading future changes in regulation, in order to exploit "first mover" advantages.

Ratings have important drawbacks, but practical alternatives are hard to find. If the decision is eventually taken to adopt risk weights on sovereign exposures, mechanisms based on fiscal sustainability indicators, such as those computed by the EU Commission or by the IMF could be considered as an alternative to – or in a suitable combination with – credit ratings.[12]

To conclude, the debate on changing the prudential regulation of sovereign exposures was prompted by the recognition that "sovereign debt is not risk-free". There is no doubt that this is true. However, at the current stage a broad agreement has been reached on the pros and cons of different reform options, not on their overall balance. My personal view is that the potential benefits of a reform are uncertain, while the potential costs could be sizeable. Be that as it may, as long as such a balance remains uncertain, a prudent stance would be to wait for the financial system to fully recover and adapt to the important set of reforms implemented since the onset of the crisis, before making further changes. This would be consistent with the approach chosen by the Governors and Heads of Supervision in their recent statement that new regulatory reforms should "not significantly increase overall capital requirements".

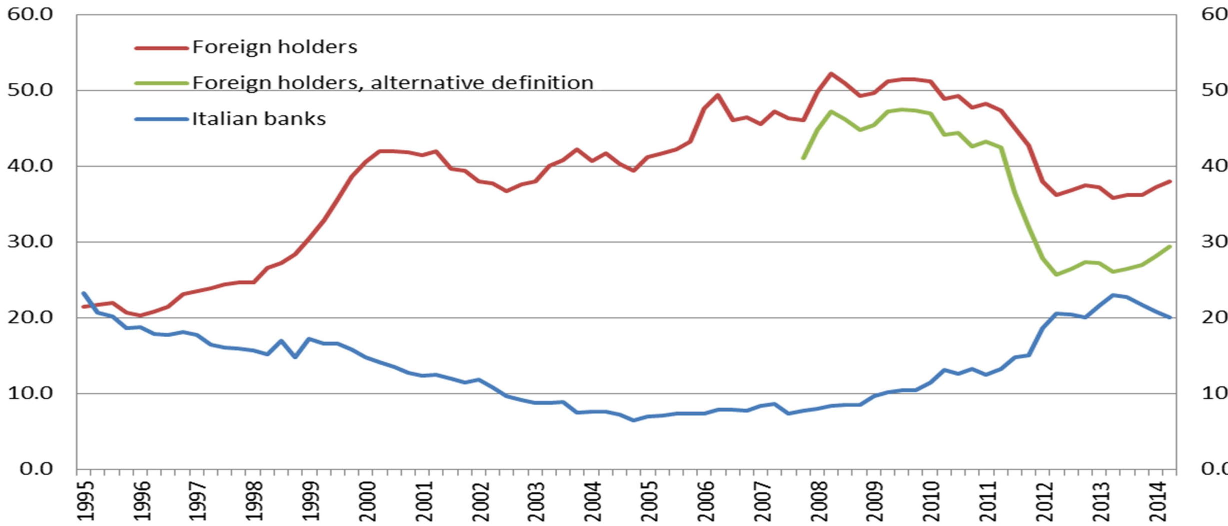
[12] European Commission, Directorate General for Economic and Financial Affairs (2012), *Fiscal Sustainability Report*, European Economy, No. 8; IMF (2014), *Fiscal Monitor*, April; Lanotte et al (2016), cit.

Figure 1 - Banks' holdings of domestic government bonds
(% of total assets)



Source: Lanotte *et al*. (2016), cit.

Figure 2 - Italian general government securities holdings by sector
(shares of total government securities outstanding; % points)



Source: Lanotte *et al*. (2016), cit.
Note: Alternative definition of foreign holders refers to foreign holders excluding Eurosystem and round-trip foreign portfolios and funds, i.e. securities held by foreign investors net of those held by the Eurosystem (excluding the Bank of Italy) and those held by foreign individually managed portfolios and investment funds but attributable to Italian investors.