EUROPEAN PARLIAMENT

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AT A GLANCE

Banks' Net Exposure to Home Sovereign

The financial and sovereign debt crisis has shown the need to address the **'sovereign-bank' nexus**, namely the problem that ailing banks can degrade the financial standing of their home country, and that a weak financial position of a country can impact the solvency of banks.

A weak banking sector can affect the solvency of the sovereign through reduced credit provision to the real economy, which negatively affects economic growth. Conversely, a bank's ties with its home country results, among other things, from its investment in bonds issued by the central government, so-called sovereign bonds.

Country	Ø Net Exposure 31/12/2013	Sample size
Latvia	0,4%	3
Denmark	0,7%	4
Sweden	1,0%	4
Finland	1,2%	3
Luxembourg	1,9%	6
UK	2,3%	4
Ireland	3,2%	5
France	3,2%	13
Norway	3,9%	1
Netherlands	4,3%	7
Estonia	4,6%	3
Austria	5,2%	6
Greece	6,0%	6
Belgium	7,2%	6
Lithuania	7,5%	3
Germany	7,7%	25
Cyprus	7,9%	4
Spain	8,1%	15
Portugal	9,1%	3
Hungary	9,8%	1
Malta	9,9%	3
Slovenia	10,0%	3
Poland	11,3%	6
Italy	11,3%	15
Slovakia	23,0%	3

In general, sovereign bonds are considered to be the **highest quality bonds** in the market exactly because they are backed by central governments. For the same reason, sovereign bonds benefit from a certain **preferential treatment** in the context of bank regulation, meaning they are typically considered to be risk-free (carry a "zero-risk weighting") and exempted from the restrictions targeting concentration risk ("large exposures"); the regulatory framework hence gives banks an incentive to invest in government debt. Banks furthermore invest in interest-bearing sovereign bonds because they are typically highly liquid assets, meaning they can easily be sold on functioning markets in case there is a need for holding ready reserves of cash, e.g. in case of unexpected large withdrawals of cash.

However, despite the preferential regulatory treatment, banks that have invested in sovereign bonds are in principle exposed to some **risks**. As noted in a recent study produced by the European Systemic Risk Board (ESRB) "*sovereign risk arises from the fact that a sovereign may, for a significant time, have higher expenditures than tax revenues and go so much into debt that, eventually, it finds it impossible or undesirable to pay its debts as they fall due or, more generally, may not comply with its contractual debt obligations*."[1] In addition to the credit risk described by the ESRB, banks that have invested in sovereign bonds are also exposed to market risk, namely interest-rate risk, inflation risk, and, if their investment is in government bonds that is not in the home currency, also exchange rate risk.

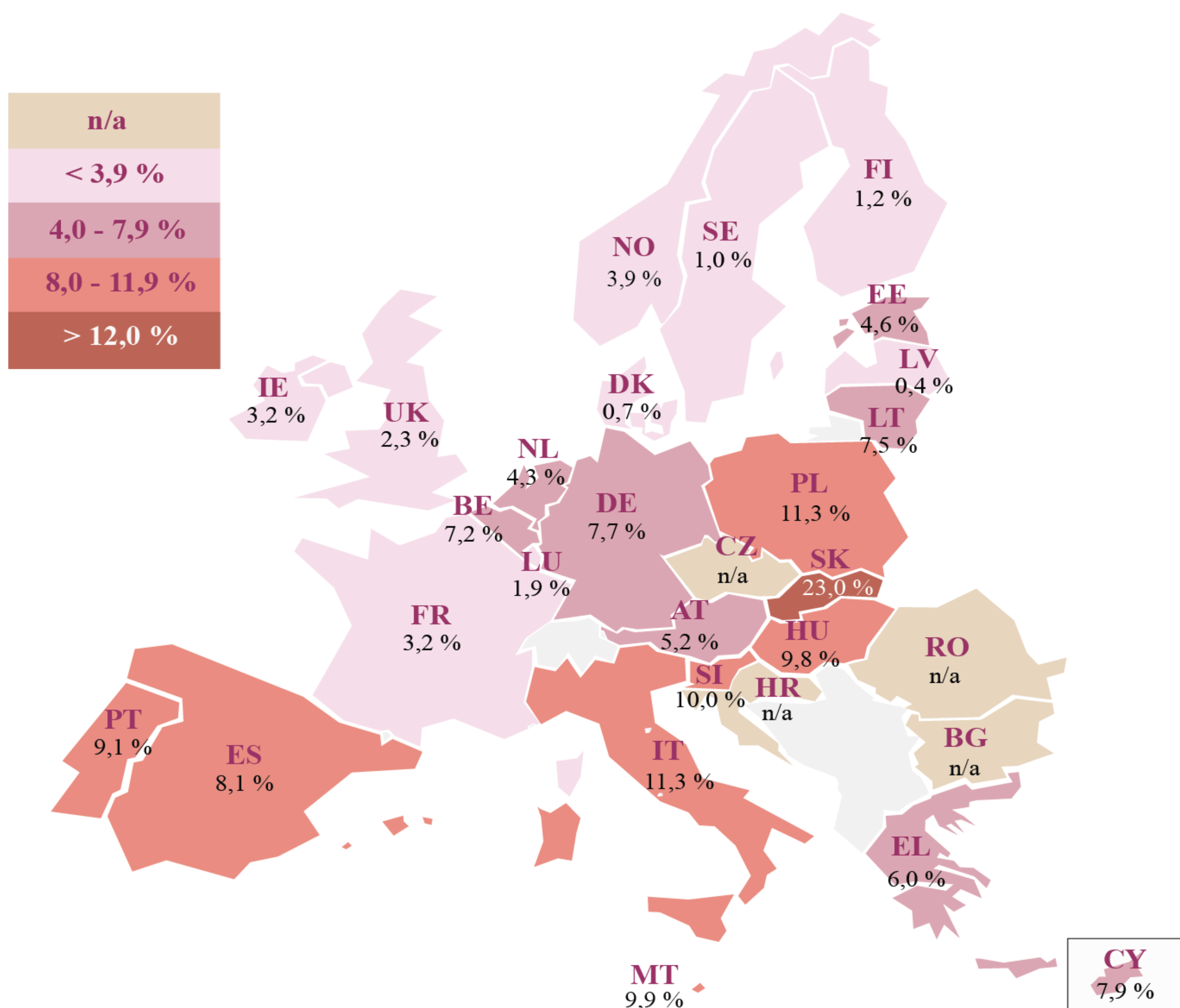
[1] ESRB report on the regulatory treatment of sovereign exposures, March 2015, p. 44f

In 2014, the European Banking Authority (EBA) and the European Central Bank (ECB) assessed in a joint exercise the financial strength of Europe's most significant banks. The ECB and EBA subsequently published detailed information at the level of individual banks, including information on banks' exposure towards sovereigns (reference date: 31/12/2013).

Using the ECB and EBA data, the adjacent map and the table overleaf summarise the **exposure of banks to home sovereigns** (calculation based on their net direct position in relation to their total assets), with averages on country level weighted according to the size of each bank in the country sample.

Please be aware that the average calculation blurs the fact that within some country samples there is considerable dispersion as regards individual bank's exposures to their home sovereign.

Map: Banks' average Net Exposure to Home Sovereign as at 31/12/2013



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