Feasibility check: transition to a new regime for banks' sovereign exposure

This note presents the summaries of two papers requested in June 2017 by the ECON Committee to external authors on "Feasibility check: transition to a new regime for banks' sovereign exposure". It also presents some relevant EU institutions' position on the subject.

Feasibility Check: Transition to a New Regime for Bank Sovereign Exposure? By Yannik M. Schneider, University of Mannheim, and Sascha Steffen, Frankfurt School of Finance & Management

In their paper, Schneider and Steffen claim that excessive sovereign debt exposures of banks contributed to the gravity of the financial and sovereign debt crisis in 2011 and 2012, as well as to the slow and asymmetric recovery of European countries. The papers shows, on the basis of simulations on a sample of European banks, that the EU banking sector would still be heavily affected if shocks to sovereign market happened. The study then presents seven policy proposals dealing with the treatment of sovereigns, and quantitatively assesses their impact on banks' balance sheets for five of them.

The authors identify four criteria that a new regime for banks' sovereign exposures should fulfil: (1) attenuate the home bias to the domestic sovereign, (2) break the doom loop, (3) avoid a flight-to-quality of assets, and (4) mitigate risk spillovers. They show that none of the proposals would fulfil all four criteria, in the absence of a safe asset. They conclude that a new regime for bank sovereign exposure should therefore be conditional on guaranteeing the value of sovereign bonds as a safe asset.

Sovereign Concentration Charges: A New Regime for Banks' Sovereign Exposures by Nicolas Véron, Bruegel & Peterson Institute for International Economics.

In his paper, N. Veron claims that achieving the aim of Europe's banking union project, i.e. to break the vicious circle between banks and sovereigns, requires new policy initiatives. In his opinion, the most direct bank-sovereign linkages are national deposit insurance and concentrated domestic sovereign exposures. Thus, simultaneously with a European Deposit Insurance Scheme (EDIS) proposed by the European Commission in 2015, the European Union should introduce regulatory disincentives against highly concentrated sovereign exposures of euro area banks.

The paper makes a concrete proposal for a Sovereign Concentration Charges Regulation (SCCR), including its calibration and careful transitional arrangements aimed at avoiding any disorderly market impact. According to the author, the SCCR and EDIS together could realistically receive political approval in 2018 and be fully implemented within a decade.

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PE 614.483 - November 2017

Some institutional positions on the subject

The **European Parliament** took the following position in February 2017: "[The EP] *considers that there are risks associated with sovereign debt; notes as well that in some Member States financial institutions have over-invested in bonds issued by their own government, leading to excessive 'home bias' while one of the main objectives of the BU is to break the bank-sovereign-risk nexus; notes that an appropriate prudential treatment of sovereign debt might create incentives for banks to better manage their sovereign exposures; notes, however, that government bonds play a critical role as a source of high-quality, liquid collateral and in the conduct of monetary policy, and that modifying their prudential treatment, especially if no phasing-in approach is envisaged, could have a significant effect on both the financial sector and the public sector, and that this necessitates a careful consideration of the pros and cons of a revision of the current framework before any proposal is made; takes note of the various policy options set out in the report of the High Level Working Group on the prudential treatment of sovereign exposures discussed at the informal ECOFIN meeting of 22 April 2016; considers that the EU regulatory framework should be consistent with the international standard; awaits, therefore the results, of the FSB's work on sovereign debt with great interest in order to guide future decisions; considers that the European framework should enable market discipline in delivering sustainable policies and providing high- quality and liquid assets for the financial sector and safe liabilities for governments; stresses that, in parallel with the reflections on sovereign debt, reflection should take place on convergence on a wider range of economic issues, on state aid rules and on risks such as misconduct, including financial crime*".

The **European Commission** reflection paper on "Deepening of the economic and monetary union", published in May 2017, reads: "*Changing the regulatory treatment of sovereign bonds is another issue under discussion to loosen the bank-sovereign loop but which would have important implications for the functioning of the euro area financial system. The regulatory treatment of sovereign debt is a politically and economically complex issue. Like in other advanced economies, EU banking legislation currently foresees the general principle of a risk-free status for sovereign bonds. This is justified by their particular role in funding public expenditure and in providing a low-risk asset for the financial system of the country concerned. At the same time, such a treatment does not provide any incentives for a bank to diversify its holdings away from home-sovereign bonds. If that treatment was changed, euro area banks would most probably react by sharply reducing their holdings of sovereign bonds. This would disrupt not only the functioning of their home financial systems. It would potentially also impact on financial stability for the euro area as a whole. At the same time, such a reform, if implemented wisely and gradually, could increase incentives for governments to reduce the risk profile connected to their own bonds*".

The **ECB Banking Supervision**'s stressed in March 2017 the following in its feedback on the European Parliament's resolution on the Banking Union Annual Report 2015: "*the single supervisor agrees that the regulatory framework [of sovereign exposures] as it stands needs to be reviewed and refined. The recent financial crisis showed that sovereign debt is not risk-free. The ECB considers that this review should be based on the following three broad principles: first, sovereign risk should be addressed under Pillar 1 and any regulatory change should come about through price effects rather than quantitative restrictions. Second, any revision to this aspect of the regulatory framework should be done very carefully in order not to impair the sovereign bond markets' key role in the functioning of financial markets and to minimise any potential negative impact on the real economy. Third, it would be important to allow for an appropriate transition period. Last, the review should be coordinated at global level to ensure an international level playing field*."

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