

## **Strengthening the banking union and the regulatory treatment of banks' sovereign exposures**

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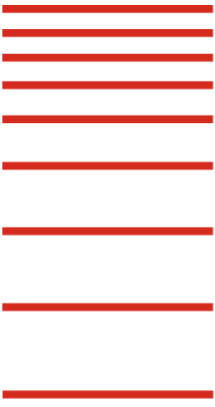
Presidency note

### **Introduction**

One of the key priorities of the Dutch Presidency is Strengthening of the Banking Union. Under the Dutch Presidency an Ad Hoc Working Party (AHWP) on this subject has been set up. The mandate of this AHWP is to establish a position of the Council on the Commission proposal for a European Deposit Insurance Scheme (EDIS) and other initiatives, including legislative proposals, which would be instrumental to the objective of Strengthening the Banking Union. Alongside the proposal for EDIS the Commission published a communication that lists several of such initiatives, including the need for a common backstop to the Single Resolution Fund (SRF) and work on the treatment of banks' sovereign exposures. Key of these initiatives is that risk sharing and risk reduction go together. The work of the AHWP will be discussed in one of the upcoming regular Ecofins during the Dutch Presidency with the goal of delivering a roadmap including a progress report on EDIS. As to the regulatory treatment of sovereign exposures, the EFC High Level Working Group (HWLG) was set up last year. In its mandate it was requested to report back to the informal Ecofin of April 2016 at the latest. It is useful to discuss this very sensitive and important subject against this overall background.

### **Banking union and the bank-sovereign nexus**

As is well-known, the link between national banking systems and sovereign debtors – the so-called sovereign-bank nexus – played a key role during the crisis. Important steps have been taken over the past couple of years to enhance the resilience of both banks and sovereigns and to address the negative spillover risks between banks and sovereigns. Measures have been taken to strengthen the fiscal position of sovereigns, including the enhanced Stability and Growth Pact (SGP). In addition, decisive measures in the banking sector have been taken, such as higher capital requirements, the introduction of the bail-in tool and the introduction of a Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF).




The EU regulatory treatment of banks' exposures to sovereigns has not been changed and is based on the Basel framework, although some aspects of the EU transposition differ from the Basel standards. The regulatory treatment in general leads to zero risk weights for banks' exposures to EU sovereigns, and does not recognise that sovereigns are not 'risk free' in practice. Exposures on sovereigns are also exempted from rules on large exposure limits.



A basic question is whether the current treatment is justified. Answering this requires a comprehensive understanding of the specific characteristics of sovereign debt, its risk profile and role in financial markets. Another question is how to assess the impact of possible changes in the regulatory treatment of exposures to sovereigns. In this context, over the past couple of months the EFC HLWG on the prudential treatment of sovereign exposures has considered the different dimensions of sovereign exposures under the current regulatory framework and looked at the implications of various policy options.

Sovereign debt is key with regard to the financing of sovereigns, bank asset and liquidity management, and as collateral in the wider financial sector. Indeed there are various reasons for banks to invest in sovereign debt, for example to manage their liquidity positions and in order to comply with liquidity requirements. The current regulatory treatment of sovereign exposures may therefore not be the main reason for banks to invest in sovereign debt, but this treatment at the same time does not put any constraints on banks to increase their sovereign exposures.

Banks can – in conjunction with other financial market actors – act as shock absorbers, enabling sovereigns to expand the budgetary stance in times of economic downturn and thereby contribute to the smooth functioning of sovereign debt markets. However it is important that shock absorption does not turn into shock amplification, which can happen when banks – in times of sovereign stress – continue to increase their exposures to an increasingly risky sovereign. When a sovereign is intrinsically insolvent, an increase in sovereign exposures by the domestic (financial) sector



may simply delay – but not avoid – a full-blown crisis and likely increase the cost of the eventual default.

Although a bank can never be insulated from sovereign stress - as it will always be indirectly and likely strongly affected by a deteriorating macro-economic climate that is associated with sovereign stress - large holdings of banks' exposures to their own sovereign, structurally increase the potential for negative spillover effects from the sovereign to the (national) banking sector. Structurally elevated home sovereign debt holdings will, thus, amplify the risk that when a sovereign defaults a systemic bank crisis will occur (twin crisis). Lower levels, on the contrary, could prevent such a banking crisis from happening or could make it less intense. Amending the current regulatory framework could provide better incentives for banks to manage sovereign risks carefully and lower spillover risks. However, the advantages of any potential change have to be carefully weighed against the structural and transitional impact on sovereign debt markets.

### **1. Policy options**

A range of possible policy options to address sovereign risk on bank balance sheets has at this stage been identified by the EFC HLWG, together with their pros and cons. Broadly speaking, they include the following:

1. ***The baseline option*** would retain the current regulatory and supervisory treatment. This includes capital requirements in Pillar 1 (risk weighted and non-risk weighted tools such as the leverage ratio), stress testing sovereign exposures and the supervisory review in Pillar 2, as well as transparency exercises and disclosure in Pillar 3.<sup>1</sup>
2. ***Further enhancements to Pillar 2 and/or 3*** beyond what is currently envisaged. This could include detailed and more harmonised guidance for supervisors on monitoring and responding to sovereign risk when it occurs at individual banks, and/or further enhancing disclosure requirements in relation to banks' sovereign exposures.

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<sup>1</sup> Pillar 1 contains the minimum capital requirements. In addition, the supervisory review process of pillar 2 identifies bank-specific risks that are not captured by the Pillar 1 minimum requirements. Pillar 3 deals with the disclosure of requirements, thereby promoting market discipline.




3. **Enhancements to Pillar 1 addressing credit risk.** Non-zero risk weights could be introduced for sovereign exposures. These risk weights would likely be low, in order to be consistent with the existing risk-weighted capital requirements framework for other types of exposures. Possible options here, include a risk weight calibration based on credit risk or a flat risk weight floor independent of the credit risk of a single sovereign.
4. **Enhancements to Pillar 1 addressing concentration risk (exposure limits).** Exposure limits would limit banks' maximum exposure to a single sovereign. These limits can be set relatively low (thereby providing strong incentives for diversification) or at higher levels.
5. **Addressing both credit and concentration risk ("hybrid option").** This combines elements of options 3 and 4 and could be shaped in various ways. One could think of "price-based large exposure thresholds" (with risk weights depending on and increasing stepwise with a pre-determined number of concentration thresholds). In this model the risk weights could be the same for all sovereigns or be differentiated based on credit risk.

## 2. Issues in transition

The calibration of transitional arrangements would first and foremost depend on the policy option chosen when amending prudential legislation.

Introducing non-zero credit risk weights for sovereign exposures, would increase banks' capital needs. This could likely be accommodated by banks in the short to medium term.

A hard large exposure limit set at a low level of eligible capital, would require a large number of banks to decrease their exposure to individual sovereigns significantly. This would at a minimum necessitate relatively long transitional arrangements, to make sure that these 'excess' exposures can to a large extent be reduced by holding these excess sovereign bonds to maturity. Part – but likely not all – of these excess sovereign exposures could subsequently be absorbed by banks in other Member States that also need to diversify their sovereign exposures. Other financial market actors may also step-in and increase their exposure to sovereign bonds, as has indeed been the



case in the aftermath of the financial crisis.<sup>2</sup> For some, the potential for large(r) market effects – including a possible reaction in interest rates – is however one of the key reasons to prefer the baseline policy option of maintaining the current treatment.

An issue that is closely related to transitional arrangements is frontloading: banks may be inclined to comply with new rules on sovereign exposures faster than required. The issue of frontloading could in particular be relevant in case of exposure limits calibrated at a low level. Some argue that this could lead to a sell-off of sovereign bonds and increased volatility: when banks realize that they need to hold less sovereign bonds of certain issuers in the future, there might be a ‘first mover advantage’ in selling bonds early, thereby exacerbating potential price dynamics. The extent to which frontloading could occur however depends on incentives for banks, supervisors and bank investors, which may differ now from previous episodes, including due to increased resilience of the banking sector. Possible regulatory amendments would in any case need to be combined with appropriate transitional arrangements.

### **3. Level of application**

When risks are perceived, they need to be addressed at the level at which they emerge (global, EU, Euro Area). The Basel Committee is currently investigating the prudential treatment of sovereign debt with a view to possible amendments to the Basel standards. This is important from the viewpoint of an international level playing field in bank legislation. The results of today’s discussion can therefore inform the European input to the Basel process.

The outcomes of the Basel trajectory are as yet uncertain and any outcome will reflect the risks perceived globally. These outcomes would then need to be implemented in the EU. In addition, members of the Banking Union (currently the Euro Area members) may

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<sup>2</sup> Against this background it is worth noting that between the beginning of 2015 and 2017 the ECB will likely buy more than €1000 Bn in sovereign bonds (current level March 2016: €630 Bn), causing record low bond yields. In December 2015 the ECB decided to reinvest the proceeds of bonds falling due, thereby adsorbing a significant share of sovereign bonds for the foreseeable future.



have a particular interest in further reducing (sovereign) risks, given the enhanced level of cross-border spillovers and risk sharing that is inherent to the Banking Union and its institutional set-up. Within the Banking Union diversification of banks' sovereign portfolios could also be achieved more easily due to the absence of currency risk within the monetary union.

Question to ministers and governors:

- Which option(s) should be further explored (in view of strengthening the Banking Union and a possible EU contribution to the Basel debate)?