Breaking the bonds that bind

Removing the sovereign-bank nexus should be a priority for policymakers before they press ahead with the European Banking Union.

The European Commission (EC) regards the creation of a full Banking Union as an essential step in making the Economic and Monetary Union (EMU) more stable and resilient to shocks, while limiting the need for public risk sharing. For the EC, the establishment of a European Deposit Insurance Scheme (EDIS) is a critical measure on the road to achieving this. However, in 2016, the Council of the European Union (EU) called for more on risk reduction measures as a precondition for EDIS.

Risk sharing and risk reduction go hand-in-hand and the close financial link between national banking systems and sovereign debtors—the so called "sovereign-bank nexus"—played a key role during the global financial crisis and subsequent eurozone sovereign crisis. Several steps have been taken since to enhance the resilience of both banks and sovereigns and to address the negative spill-over risks between the two, such as the creation of common supervisory and resolution powers. However, the preferential treatment of banks' exposure to sovereign bonds under the EU's Capital Requirement Regulation (CRR) so far remains unchanged. Some member countries led by Germany argued that the regulatory treatment of government bonds has to be amended as a precondition of EDIS to break the sovereign-bank nexus.

Current treatment under CRR

Under current regulatory requirements, EU government bonds receive special treatment that applies inter alia to capital requirements and regulation on large exposures.

Some EU Member States argue that the regulatory treatment of government bonds needs to be amended to break the sovereign-bank nexus

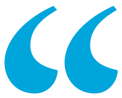
Banks are required to back their holdings of instruments including government bonds with appropriate levels of equity. The capital requirements are commensurate with the underlying credit risk in line with the objective of ensuring risk sensitivity. Under the Standardised Approach, which relies on external credit ratings, exposures to EU governments are assigned a zero-risk weight. Thus, no equity capital is required for EU government bonds irrespective of the credit rating of an individual Member State. But the Internal Ratings Based Approach (IRB Approach), which relies on banks' internal rating models, does not automatically result in a zero-risk weight for EU government bonds. Even so, banks using the IRB Approach are also allowed under CRR to assign a zero-risk weight. Firstly, CRR does not provide for a minimum probability of default for sovereign exposures relative to other asset classes. Secondly, the IRB Approach allows banks to apply the Standardised Approach for their exposures to EU government bonds and consequently apply the zero-risk weight.

EU government bonds also receive preferential treatment when it comes to limits on large exposure. Under CRR, exposures to any counterparty are limited to 25 percent of the bank's own funds in order to avoid risk concentration. However, EU government bonds are exempted from those large exposure limits, allowing a bank to hold government bond exposures that go beyond the stated threshold.

Rationale for special treatment of government bonds

The original rationale underpinning the special treatment of government bonds was the assumption that government debts are risk-free because a sovereign debtor is very solvent due to its power to raise taxes and other compulsory levies. In addition, a country's central bank is generally able to fulfil the government's commitments denominated in the domestic currency on a potentially unlimited basis.

However, under EMU, the fiscal authorities of Member States have no influence on the European Central Bank's monetary authority. Furthermore, the "no bailout clause" in the Treaty of the Functioning of the European Union prohibits central bank intervention. While the European Stability Mechanism (ESM) was created to serve as a backstop for euro area countries experiencing, or threatened by, severe financing problems, it cannot fully escape the conclusion that sovereign debts in the euro area are subject to a credit risk.



Any adjustment of the regulatory treatment of government bonds needs to be combined with appropriate transitional arrangements

Another reason put forward to justify the current treatment of government bonds is their particular role in funding public expenditure in the interest of discharging public budgets.

Options for reform

Following the financial crisis, a public debate has emerged about amendments to the regulatory treatment of government bonds to break the sovereign-bank nexus. Due to the potential market effects and the potential consequences for both banks and sovereigns, this issue is regarded as particularly sensitive. EC is awaiting the outcome of the Basel Committee's review of the regulatory treatment of government bonds. However, the Committee has not yet reached a consensus to make any changes and decided in December 2017 to consult on certain ideas because longer-term thinking on this issue is considered necessary.

The options include the introduction of positive risk weights for sovereign risk exposures. These risk weights could vary depending on the rating of the individual sovereign. Another option would be the introduction of sovereign exposure limits, which would force banks to have a more diversified portfolio of holdings.

Both of these options would have advantages and disadvantages. Positive risk weights would boost capital buffers, thereby increasing the resilience of banks but also their funding costs, while vulnerable countries would pay higher interest rates in order to borrow.

The introduction of exposure limits would encourage banks to diversify their portfolios away from domestic sovereign bonds. This would help remove distortion and increase incentives for sovereigns to reduce the risk profile connected to their own bonds. However, the attractiveness of sovereign bonds for banks would be reduced, and a large number of banks would be required to decrease their exposure to individual sovereigns and to readjust their sovereign bond portfolio.

Therefore, in order to prevent market disruptions, any adjustment of the regulatory treatment of government bonds needs to be combined with appropriate transitional arrangements such as a grandfathering for the large exposure limits or increasing risk weights over a period of multiple years.

It remains to be seen whether European policymakers will agree to amend the treatment of sovereign bonds under CRR in the interest of further reducing sovereign risks rather than maintaining the current preferential treatment with regard to potential large-market effects including possible reactions in interest rates. Reform of the regulatory treatment could be supported by some financially strong Member States, such as Germany, in order to reduce the level of sovereign risks on bank balance sheets and thus cut the sovereign-bank link. Conversely, countries that would be particularly affected by an amendment of the regulatory framework for government bonds, such as Italy, are likely to resist any changes of the current preferential treatment. However, in view of the current plan to decide on the roadmap to EDIS by June 2018 and the ongoing discussions of the Basel Committee, it is uncertain if amending the regulatory treatment of government bonds will still be considered a precondition for EDIS.

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