EUROPEAN ECONOMY
BANKS, REGULATION, AND THE REAL SECTOR

SOVEREIGN AND BANKING RISKS: WHAT POLICIES?

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"Sovereign and banking risks: What policies?"

- This fourth issue of "European Economy – Banks, Regulation, and the Real Sector," examines the diabolic loop between banks and sovereigns
- Three issues are touched:
  - are bank-sovereign crises in a monetary union different?
  - were interventions to tame the diabolic loop in the Eurozone appropriate?
  - what is the optimal regulatory setting and how can it be implemented?

Main conclusions

- The implementation of some risk sharing mechanisms during the crisis allowed us to tame the diabolic loop…

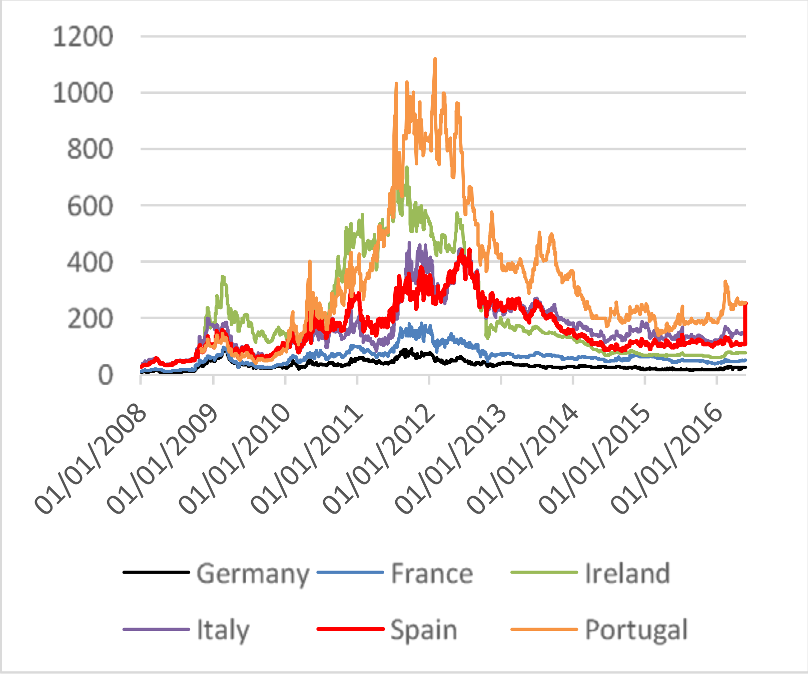
  …but made it unsustainable to keep considering all sovereigns equally risk free
- The presence of risk sharing mechanisms requires that different degrees of riskiness are recognized
- In the longer run, the bank-sovereign loop in the Euro area can only be severed by:
  1. enhancing risk sharing within the Union
  2. recognizing and addressing risk asymmetries among sovereigns
- **These two elements are inevitably tangled together and need to be addressed together…**

  …but taking due care of the transition path and using all possible tools offered in economics

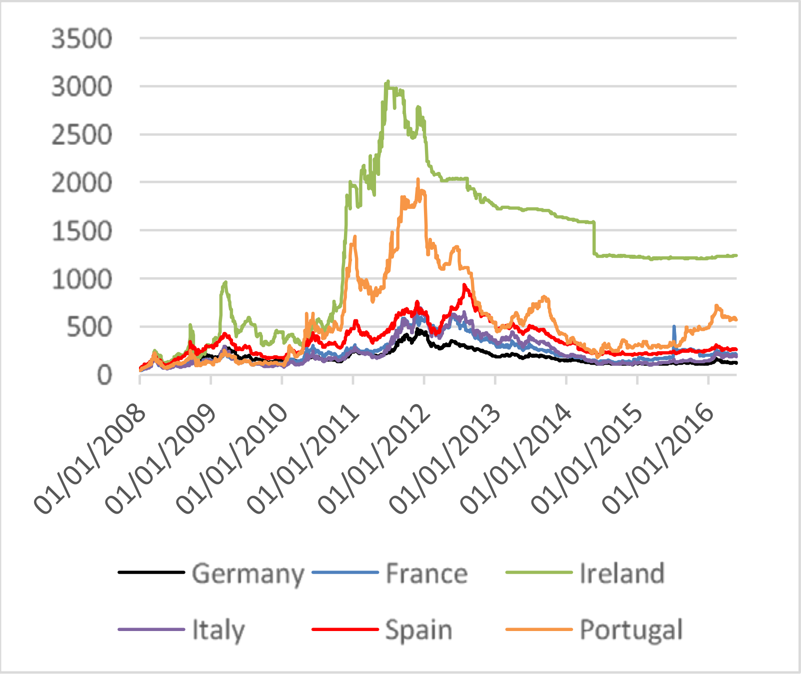
The Eurozone “diabolic loop” of 2010-2011

- No OECD country defaulted on its domestic debt between 1950 and 2010 (Reinhart and Rogoff, 2008)
- Nonetheless, a diabolic loop between banks and sovereigns was particularly clear in the Eurozone in 2010-2011, and partly in 2009

Sovereign bond 10-year CDSs



Bank 5-year CDSs



Diabolic loops in monetary unions

- The central bank of a country with its own currency can purchase sovereign bonds in times of distress: the only side effect of the impact on price stability
- In a monetary union:
  - on the one hand, interventions by the central bank in support of distressed sovereigns can be seen as an unwarranted backing of some individual member countries…

    …but, on the other, a sovereign-bank crisis loop in one country can cause huge negative externalities to other countries
- This calls for:
  - swift decisions by the central bank on possible interventions
  - stronger mutualisation of sovereign risks
- **In the aftermath of the financial crisis of 2007-2008 neither of these two mechanisms were active**

Were interventions in 2010-2011 appropriate?

- The spiral of the Sovereign crisis was tamed when part of these interventions took place:
  - some risk sharing mechanisms were implemented (e.g., ESM)
  - the ECB intervened as lender of last resort (LTROs) and potential buyer of last resort (OMT)
- Banks in GIIPs bought domestic government bonds, making large carry-trade profits but increasing their exposition to sovereign risk (Acharya and Steffen, 2016)
- But they could not lend more to the private sector, because:
  - they had limited equity
  - they were constrained on the liability side
- **Even with a more stringent regulation on sovereign expositions, there are many reasons to believe that the outcome at that time could have been worse**

The equilibrium under “normal conditions”

- Even in the long-run, Europe is likely to face asymmetries that call for:
  - incentives to explicitly account for, and possibly reduce them
  - the completion of the risk sharing mechanisms entailed in the Monetary and Banking Union
- To address the first issue, three families of regulatory measures have been proposed:
  - non-zero risk weights on sovereign bonds held by banks
  - partial or full lift of the exception to the large exposure provision
  - limits to the use of sovereigns to comply with liquidity requirements (LCR and NSFR)

“Horizontal discrimination”

- Full risk weights and no exceptions to the large exposure provision introduce an “horizontal discrimination” (Andritzky et al., 2016)
- “Horizontal discrimination” has some **good effects**:
  - it limits the “diabolic loop”
  - it creates incentives to reduce fiscal imbalances…

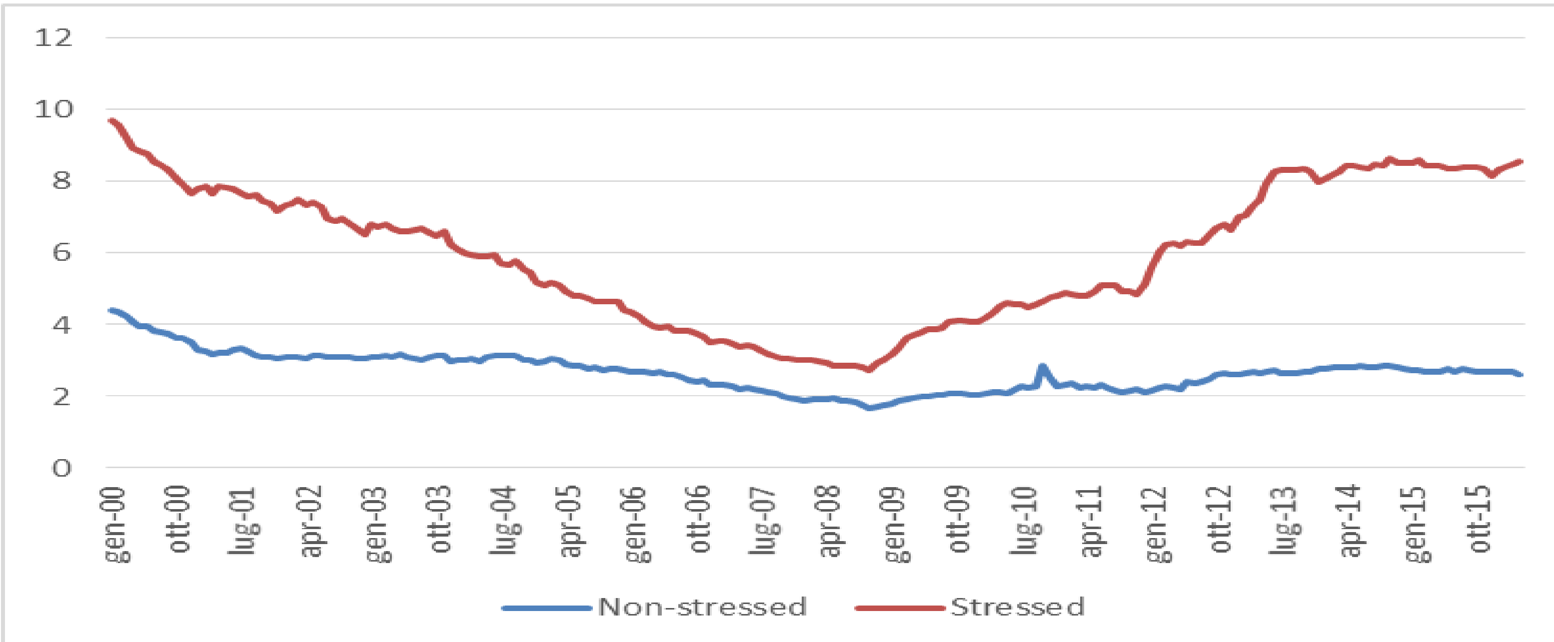
  …and some **less good** ones:
  - it increases the costs of funding of weaker sovereigns
  - it reduces the amount of bonds that can be used as “risk free assets”
- In addition, in the transition period:
  - risk weights can hinder the recovery due to pro-cyclicality (Nielsen, 2016)
  - limits to sovereign exposures can cause large portfolio adjustments and huge price fluctuations (Lanotte et al., 2016)
- Impacts are very non-linear and a small initial shock may give rise to self-fulfilling speculative attacks on some banks or sovereigns

“Vertical discrimination” - ESBies

- Alternatively one can combine “horizontal” and “vertical discrimination” (Brunnermeier et al. 2016; Pagano, 2016; Corsetti et al. 2016):
  - a private based financial entity acquires a portfolio of bonds issued by all member countries of the Euro area, with shares based on an objective parameter (e.g., nominal GDP)
  - this entity issues asset backed securities using tranching
- Even with just two tranches, the most senior would have larger size and better risk characteristics than risk-free sovereign bonds
- Banks would be holding by construction a diversified portfolio, so that:
  - there would be no need to impose concentration limits
  - capital requirements would not be binding
  - demand shortages for bonds in vulnerable countries are unlikely
  - a large pool of low-risk assets is created
  - self-fulfilling crises are unlikely
- Some caution is needed on the allocation of the junior tranche

Wrapping-up

Domestic sovereigns held by MFIs to total assets
(non-stressed and stressed countries)



- **Opening a new market generally improves welfare: ESBies are not just an academic curiosity**
- **Together with enhanced risk sharing, ESBies can be a viable policy option**

What's Next?

- Issue V 2016:

"Banks' resolution and the mutualisation of risk in the Banking Union"

THANK YOU

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