EUROPEAN ECONOMY
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SOVEREIGN AND BANKING RISKS: WHAT POLICIES?

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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
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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