Banks’ holding of sovereign debt: a proposal for the euro area

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Breaking the bottlenecks – steps towards sustainable growth
Athens June 8° 2016
The euro area is at risk of disintegration
At the core of the problem ....

• The fiscal framework based on “rules” is broken

• We have tools to deal with sovereign liquidity problems (ESM) but not with insolvency problems ....

  ➢ Ex ante this creates incentives for excessive debt

  ➢ Ex post this leads to ad hoc solutions and forces to chose between unorderly default and a combination of excessive austerity with ESM/EFSF involvement ... at huge costs ...

• The banking union is incomplete and no step forward seems to be possible at this stage
Desirable features of a robust long run framework

- **Fiscal regime**: A credible commitment to prevent excess debt build-up
- **Financial regime**: A diversified financial system that is not vulnerable to own sovereign risk

Financial regulation has to be consistent with and reinforce the fiscal regime proposal
A recent CEPR proposal: Corsetti, Feld, Kojien, Reichlin, Reis, Rey and Weder di Mauro 2016

1. Steady state fiscal regime – introduce a sovereign debt restructuring regime
   ▶ amend ESM lending policies: credibly commit not to lend into insolvency
   
   PRINCIPLE: The ESM should play the gatekeeper role - Thresholds for risk of debt distress – Above threshold reprofile or debt reduction operation

2. Steady state financial regime: change the regulation on sovereign bonds treatment for capital charges and create incentive for market creation of a diversified synthetic bond suitable as target for ECB monetary policy operations

3. Proposal for dealing with instability due to transition to the new regime – one off coordinated policy to eliminate the legacy debt (debt by-back)

WILL FOCUS ON 2
Proposal for new steady state financial regime

Motivation

• Strong home bias is generally the result of risk aversion
• In the EMU strong home bias in sovereign market since the debt crisis ... partly due to moral suasion and fear of redenomination risk
• Encouraged by the fact that all sovereign bonds of euro area are treated in the same way for capital charges
• This + the fact that no restructuring possible lead sovereign market investors to oscillate between excess relaxation and excess paranoia

Consequences:

- correlation between bank and sovereign risk (diabolic loop)
- Single monetary policy difficult to implement if financial fragmentation – no euro area wide safe asset
Where do we stand today?

- The sovereign-bank loop is still with us and its resolution is seen by some as a prerequisite for the implementation of the third pillar of the Banking Union (deposit guarantee).

- The German position: no sharing of risk without mitigation of risk ... propose to introduce capital charges on sovereign holding – various proposals on the table all leading to potentially large portfolio shift and instability.
Sovereign exposure large and heterogeneous across institutions

Net Sovereign Exposure over Total Assets

Source: EBA, UCG
Strong home bias in most countries

Source: ECB

Domestic / EA gov. debt holdings (MFI excl. ESCB, %)
Strong home bias
many institutions are above the threshold on limited exposure under discussion

Home country Net Sovereign Exposure as % of eligible capital (own funds),

Source: EBA, 2015
EU-wide transparency exercise data set
Our solution: a hybrid promoting diversification + impose risk weights

**Step 1 - Diversification**

- Regulators (not rating agencies) impose risk weights on sovereign debt in a manner that is consistent with steady state fiscal regime. For example
  - <60%: zero RWA (Tier 1)
  - 60-90%: x% RWA (Tier 2)
  - >90%: y% RWA (Tier 3)

- The whole of a country’s public debt attracts the same % RWA, calculated as the *weighted average* of the different risk weights, depending on how much debt is in each of the three tiers.
1. The ECB would set RWA rules so that each sovereign’s debt attracts different RWAs according to that country’s debt-to-GDP ratio.

2. The RWA rules would identify bands of debt-to-GDP, each carrying a different RWA ratio.

3. The bands would operate on a marginal basis, so that each country’s debt would carry a single RWA ratio, calculated from the combined effect of the bands.

4. The RWA calculation, and the determination of the debt-to-GDP ratio, would be made periodically.
... not enough to create a safe asset

- On its own, assigning differential levels of RWAs according to levels of debt-to-GDP would create an incentive to diversify banks’ portfolios away from domestic sovereigns.
- It would also be relatively simple to implement, and would not cause problems of instability in transition as portfolio shifts would not be dramatic.
- However, it would not create a safe asset.

Need a second step
Our Solution

Step 2 – encouraging the creation of a safe asset

- The ECB introduces a registration scheme to encourage private sector creation of collateralised debt obligations (CDOs)
- CDOs backed by portfolios of eurozone sovereign bonds divided into tranches
- Register tranches: each would attract different quantity of RWAs
  - To qualify, a CDO must be backed by a portfolio of sovereign bonds held in certain proportions (e.g., % of EZ GDP or ECB keys)
  - Different tranches are given different seniority and each are designated to attract different RWAs [Series A of the registered CDO would play the role of the EZ safe asset]
Step 2: Encouraging the Creation of a Safe Asset

1. To qualify, the CDO would need to be backed by a portfolio of sovereign bonds in proportion to shares of EA GDP.

2. The ECB would register each of the tranches and would allocate RWAs to each series.

3. The size of tranche A would be set by the amount of each country’s bonds that could be held consistent with a [60%] debt-to-GDP ratio. This series would be allocated zero RWAs.

4. Similarly, the size of tranche B would be set so that the amount of each country’s bonds backing it would fall into the next RWA tier. Tranche C would be the residual, at the top RWA tier.

Portfolio of sovereign bonds (millions)

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>32.5</td>
</tr>
<tr>
<td>Belgium</td>
<td>39.4</td>
</tr>
<tr>
<td>Italy</td>
<td>157.8</td>
</tr>
<tr>
<td>TOT CDO issue</td>
<td>1000</td>
</tr>
</tbody>
</table>

Sub-portfolio backing

<table>
<thead>
<tr>
<th>Tranche</th>
<th>Sub-portfolio backing</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Austria 22.86, Belgium 21.75, Italy 70.34</td>
</tr>
<tr>
<td>B</td>
<td>Austria 9.64, Belgium 10.87, Italy 35.17</td>
</tr>
<tr>
<td>C</td>
<td>Austria 0.0, Belgium 6.78, Italy 52.29</td>
</tr>
</tbody>
</table>

Sub-portfolio backing Tranche A

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>22.86</td>
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<td>21.75</td>
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<td>Italy</td>
<td>70.34</td>
</tr>
</tbody>
</table>

Sub-portfolio backing Tranche B

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>9.64</td>
</tr>
<tr>
<td>Belgium</td>
<td>10.87</td>
</tr>
<tr>
<td>Italy</td>
<td>35.17</td>
</tr>
</tbody>
</table>

Sub-portfolio backing Tranche C

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>0.0</td>
</tr>
<tr>
<td>Belgium</td>
<td>6.78</td>
</tr>
<tr>
<td>Italy</td>
<td>52.29</td>
</tr>
</tbody>
</table>

5. The effect of these rules would be to ensure the ‘conservation of RWAs’. I.e., the total RWAs attracted by the CDO issue would be the same as if all the bonds in the supporting portfolio were held directly by banks.

6. In addition, the rules would stipulate that in order to be allocated zero RWAs, Tranche A had to rank senior to Tranche B, etc.
Additional intervention to effect the creation of safe assets

- The ECB could underwrite the liquidity of these CDOs by incorporating them in its monetary policy operations.

- The ECB could go further by acting – via the ESM – as the originator of such CDOs, taking advantage of the PSPP to do so.
Remarks (1)

• These RWA rules would create an incentive for market participants to create qualifying CDOs, and these securities would provide an attractive vehicle for investment by banks seeking to diversify their portfolios away from domestic sovereigns.

• However, the attractiveness of these CDOs as alternatives to domestic sovereign bonds would depend critically on their liquidity.

• That in turn would depend on (i) the size of such CDO issues, and (ii) the commitment of market participants to act as market makers.
Remarks (2)

• The RWA rules mean that Tranche A attracts lower RWAs than domestic sovereign bonds for banks in more indebted countries.

• A commitment by the ECB to use these CDOs in its monetary operations should also go a long way to ensure that they have adequate liquidity.

• However, if the ECB also used its sovereign bond buying (including the PSPP programme) to act as the originator of such CDOs, then it could ensure issue sizes were large enough to guarantee liquidity.

• Tranche A CDOs should also meet the criteria for qualification as ‘High Quality Liquid Assets’ (HQLAs) for the purposes of the ECB’s new Liquidity Coverage Ratio (LCR).
Advantages of our hybrid proposal

*promoting diversification + impose risk weights*

- It ensures some risk-absorption capacity for sovereign while still allowing the market to enforce discipline: enhance sovereign risk pricing and market discipline

- Creates a permanent safe asset without mutualization (CDO Series A) – valuable for financial institutions and ECB monetary policy

- Enables diversification without large portfolio shifts

- Consistent with fiscal framework allowing for debt restructuring but minimizes disruptions caused by the transition to this new regime
Thank you!
MFIs: Gov. Securities / Total Assets

- CEPR recessions
- Extra EA
- Other EA
- Domestic
Public Debt currently exceeds 60% of GDP

Yes

Country is classified as in excess debt: Requires an Excess Debt Analysis (EDA)
- Baseline scenario; stress scenario; vulnerability analysis
- Reporting of Risk Map

Yes

Public currently projected or under stress exceeds 90% debt to GDP ratio
and/or
Gross financing needs current, projected or under stress exceeds 20% of GDP
Country is classified as “country at risk of stress distress”

Yes

Country loses market access

Yes

ESM can provide access on the basis of:
- Debt reduction operation or
- One-time repackaging (extension of maturity) with an adjustment programme sufficient to regain market access
# Solutions discussed

<table>
<thead>
<tr>
<th>Description</th>
<th>Option A: limit % exposure to any sovereign (a cap)</th>
<th>Option B: market-based risk weights</th>
<th>Option C: diversification-based risk weights</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total exposure to any sovereign limited to &lt;[25%] of T1 capital</strong></td>
<td><strong>Weights set by reference to either (i) market prices for sovereign’s debt, or (ii) credit ratings</strong></td>
<td><strong>Baskets of bonds held in proportion to countries’ share of total GDP attract zero RWAs</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Pros</strong></td>
<td><strong>Transparent; easy to understand and implement</strong></td>
<td><strong>Creates incentive to increase loss absorption capacity</strong></td>
<td><strong>Encourages the creation of a safe asset; less instability in transition as portfolio shifts more limited</strong></td>
</tr>
<tr>
<td><strong>Cons</strong></td>
<td><strong>Pro-cyclical; may create incentive to hold risky sovereign debt; does not help to create a European safe asset</strong></td>
<td><strong>Pro-cyclical (especially if market measures used); difficult/de-stabilising in transition (portfolio shifts); risky when starting from a high level of legacy debt</strong></td>
<td><strong>Need to make sure that market discipline works. Won’t be safe if it aggregates most of the Euro Area debt (it is not joint liability)</strong></td>
</tr>
</tbody>
</table>