Letter from the Federal Ministry of Finance's Advisory Board to Federal Minister of Finance Dr Wolfgang Schäuble[1]

Berlin, 20 January 2017

Treating the causes of the sovereign-bank nexus

Ever since the crisis in the euro area began in 2010, policy-makers and analysts have raised the issue of the "sovereign-bank nexus", which is viewed as a core problem in efforts to overcome the crisis and stabilise the euro area. This concept refers to the tight financial linkages between states and banks, which can set a potential vicious circle in motion:

1) In cases where banks have run into trouble, states have all too frequently had to rescue them, particularly if such banks were viewed as systemically important. This meant that losses incurred by banks got nationalised, i.e. they were shifted from the private to the public sector, and sovereign default risks increased as a result.

2) Conversely, in cases where states have experienced financial shortfalls (due, for example, to excessive levels of sovereign debt or the costs of large-scale rescue packages for banks), this has caused problems for banks that had previously acquired sizeable amounts of those states' sovereign bonds.

During the course of the crisis, experts and policy-makers have devoted significant attention to the question of how this nexus can be disrupted. For example, the establishment of common supervisory and resolution powers – on the basis of the

[1] Authorized translation. The original letter is published in German at the Website of Federal Ministry of Finance: http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Ministerium/Geschaeftsbereich/Wissenschaftlicher_Beirat/Gutachten_und_Stellungnahmen/Ausgewaehlte_Texte/2017-01-24-ursachengerechte-therapie-des-staaten-banken-nexus-anlage.pdf?__blob=publicationFile&v=2.

Single Supervisory Mechanism (SSM), the Bank Recovery and Resolution Directive (BRRD), and the Single Resolution Mechanism (SRM) – aims to provide sovereigns with better protection against bank risks. In contrast, regulatory advances to reduce banks' vulnerability to sovereign debt crises are less apparent. Essentially, banks should be induced to reduce their investment risks and to increase their capacity to absorb potential losses.

Already in 2014, the Advisory Board to the Federal Ministry of Finance argued that policy-makers themselves are largely responsible for banks' vulnerability to sovereign debt crises and, among other things, proposed three changes to regulatory policy: (1) higher capital requirements in general, (2) the regulatory prevention of risk concentration on bank balance sheets caused by excessive investment in the government debt instruments of a bank's home country (home bias[2]), and especially (3) ending the preferential treatment of government debt instruments as a form of investment, particularly by eliminating the exemption of these instruments from capital requirements rules.[3]

Changes to bank regulatory policy that take these three points into account would induce banks to scale down their portfolio of government debt instruments generally, to reduce current high levels of home bias, and thereby to increase portfolio diversification. At the same time, stronger capital positions would make banks less vulnerable to potential investment losses triggered by sovereign debt crises. Under this strategy, it is left to the discretion of the private financial sector whether the desired portfolio diversification occurs through suitable investments by individual banks, or whether investment houses facilitate this diversification process by creating suitable derivatives (i.e. the pooling and tranching of bonds).

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[2] Home bias is when investors exhibit a decidedly stronger preference for domestic equities, despite the benefits that a more diversified portfolio allocation would bring.

[3] *Der Staat als privilegierter Schuldner – Ansatzpunkte für eine Neuordnung der öffentlichen Verschuldung in der Europäischen Währungsunion* ("The state as privileged debtor – a strategy to reorganise public debt in the European Monetary Union"), position paper by the Advisory Board to the Federal Ministry of Finance, February 2014 (available in German only).

Current policy discussions do not place the first priority on ending the preferential treatment of government debt instruments. Instead, they focus more on the introduction of so-called sovereign bond-backed securities (SBSs)[4]. This involves securitising government bonds and separating them into senior and junior tranches. The aim here is to create an asset class that would enable banks – by investing in the senior tranche of SBSs – to maintain a secure and diversified portfolio of government bonds. Another aim would be to prevent – in cases of crisis – the flight of capital from countries in poorer fiscal condition to countries in sounder fiscal condition. The intention would be to improve resilience and to reduce the need to rescue banks, thereby benefiting all euro area countries, including Germany and its export-oriented economy. In contrast to eurobonds, SBSs would not explicitly mutualise member state liability for sovereign debt, because the bonds would continue to be issued by the individual member states.

The proposal to introduce SBSs as an euro area reform measure is surprising in that it would already be possible today to offer such products at any time. If demand for a secure asset class like this actually existed, then the proposed mechanism of purchasing government bonds and issuing them in two tranches could already today be offered by private institutions. One reason for the fact that no private initiative to offer SBSs has emerged could be the preferential regulatory treatment of government bonds. At present, SBSs are less attractive to banks than government bonds: holdings of government debt are subject neither to capital requirements nor to limits on large exposures. In contrast, tranches of securitised bonds are subject to both of these restrictions. This disadvantage may explain why the pooling and tranching of government bonds has so far played no role on private capital markets. The above-described proposals by the Advisory Board would eliminate this discrimination against securitised bonds – not by expanding preferential treatment to these types of derivatives

[4] This concept harkens back to a reform proposal outlined in Brunnermeier, M.; Langfield, S.; Pagano, M.; Reis, R.; Van Nieuwerburgh, S.; Vayanos, D. (2016). ESBies: Safety in the tranches, Working Paper 21 (September 2016), ESRB Board.

but by addressing the cause and ending the preferential treatment of government debt instruments themselves.

However, this regulatory aspect does not fully explain why such products have so far not emerged on financial markets. Unregulated participants on capital markets – in particular, private investors – are not subject to investment restrictions and could demand SBSs if they wanted to. But evidently no such demand exists at present. This underscores how important it is to end the preferential treatment of government bonds. If this were to happen, then markets would demonstrate whether sufficient demand for SBSs exists. The decisive factor here would be whether such products could succeed in capital markets under neutral regulatory conditions – i.e. regulation that reflects actual risk without the unwarranted preferential or discriminatory treatment of government bonds or securitised products such as SBSs – and without further state intervention. It is important to warn against reforming financial markets with the aim of making it more attractive to hold SBSs, for example by extending the preferential treatment of government bonds to cover SBSs as well.

There are additional problems that weigh against adopting regulatory reforms to create SBSs. In particular, the euro area's rules and institutions have come under intense political pressure in periods of crisis, i.e. precisely at times when such rules and institutions must prove their effectiveness. This was the case, for example, with the widespread violation of the stability criteria on sovereign debt; the European Commission's generous approach toward excessive deficits; and the issue of whether or not to enforce the strict application of the BRRD. These are examples that demonstrate the insufficient credibility of rules, which in turn undermines compliance. A similar situation is to be feared with SBSs: they risk turning into a slippery slope towards a comprehensive and undemocratic mutualisation of sovereign debt. The experience that has been gathered with the violation of rules and laws at European level must be taken into account when assessing the proposal to introduce SBSs.

SBSs would be particularly susceptible to attempts to exert political influence. In principle, such securities would be created by the private sector; however, if the returns on bonds from individual countries were to rise at a pace deemed politically unacceptable, calls would quickly arise for state intervention in the pricing of such bonds. The spectre of purported market failure would thus provide an easy argument for doing everything necessary to make sure that countries with less sound finances could sell their bonds at favourable conditions. Furthermore, the establishment of a public or private securitisation body at the instigation of EU institutions could engender expectations that, if troubles were to arise, steps would be taken to avoid payment defaults (and reputational damage) and to thereby compensate investors – at the expense of the community of participating member states. The result of such an intervention would be the introduction of eurobonds through the back door.

In addition to these fundamental risks that stem from the insufficient reliability of European agreements, other serious problems would arise in connection with the practical implementation of SBSs: (1) They would give rise to a variety of sizeable transaction costs that would increase with the number of countries participating in an SBSs regime. (2) They would lead to counterparty risks through the institution that buys the government debt instruments, transforms them, and re-sells them in the form of certificates. (3) The complexity of contractual arrangements would give rise to a significant level of intransparency and legal uncertainty.

All of the above points raise considerable doubts as to whether the introduction of sovereign bond-backed securities is a step in the right direction. In any case, it is essential to acknowledge the new risks and open questions. These include above all the danger that, in the course of this reform process, the preferential regulatory treatment of sovereign debt will be extended rather than eliminated, even though the elimination of such preferential treatment is urgently needed in order to prevent future crises. For this reason, the Advisory Board recommends an approach that addresses the causes and that puts an end to the sovereign-bank nexus by adopting the set of

measures described above, focusing in particular on establishing incentives to diversify bank portfolios in combination with increased capital requirements. These are the measures that economic policy in Europe should focus on.