Banking Union at 10: Sovereign-bank nexus unresolved, challenges ahead

Volker Wieland
IMFS, Goethe University Frankfurt and EBI

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What‘s new: The good, the bad and the ugly

Good: euro area banks have come through the banking stress of 2023 following the collapse of SVB, Signature and Credit Suisse surprisingly well.

Not good: bank profitability remains low, barriers to consolidation high, banks in crisis tend to be dealt with nationally, no European deposit insurance,

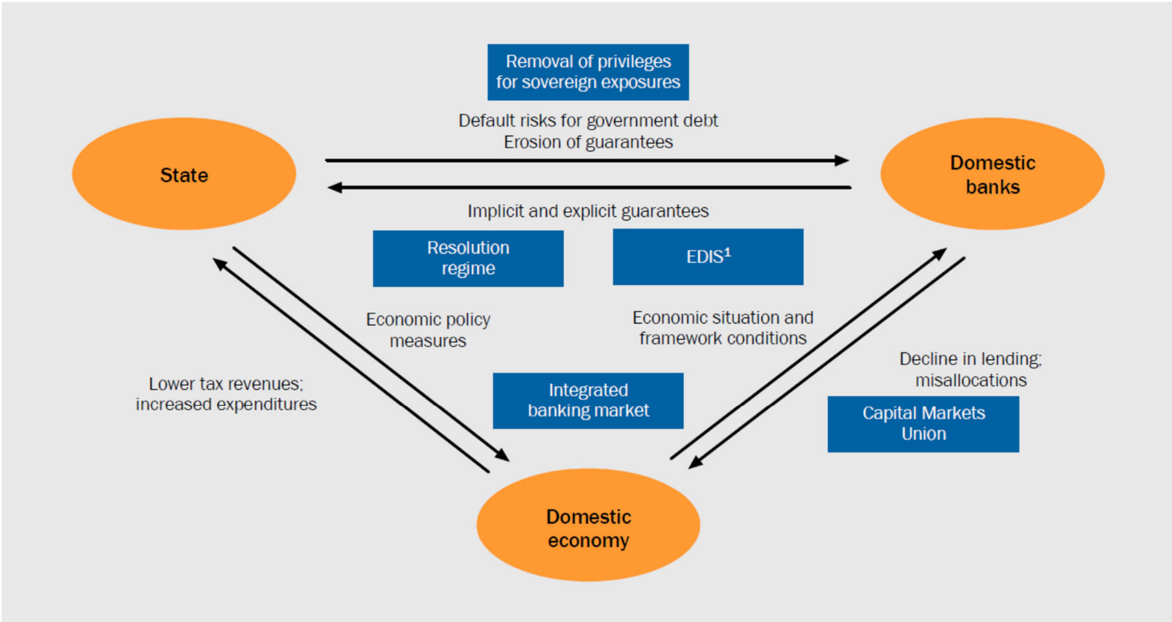
Bad: Bank exposures to own sovereigns remain high, regulatory privileges of those sovereign exposures have not been removed

Ugly: Highly indebted sovereigns face higher interest rates, interest expenditure will rise a lot over time, fiscal rules have been weakened, while ECB stop gap measures were enhanced

Dangerous cocktail for the future.

Severing the sovereign-bank nexus is a central objective of banking union

Selected channels of contagion between banks and sovereigns in the euro area



Reform proposals of German Council of Experts: 2015 & 2018

Deepen banking union by removing privileges to the regulatory treatment of sovereign exposures

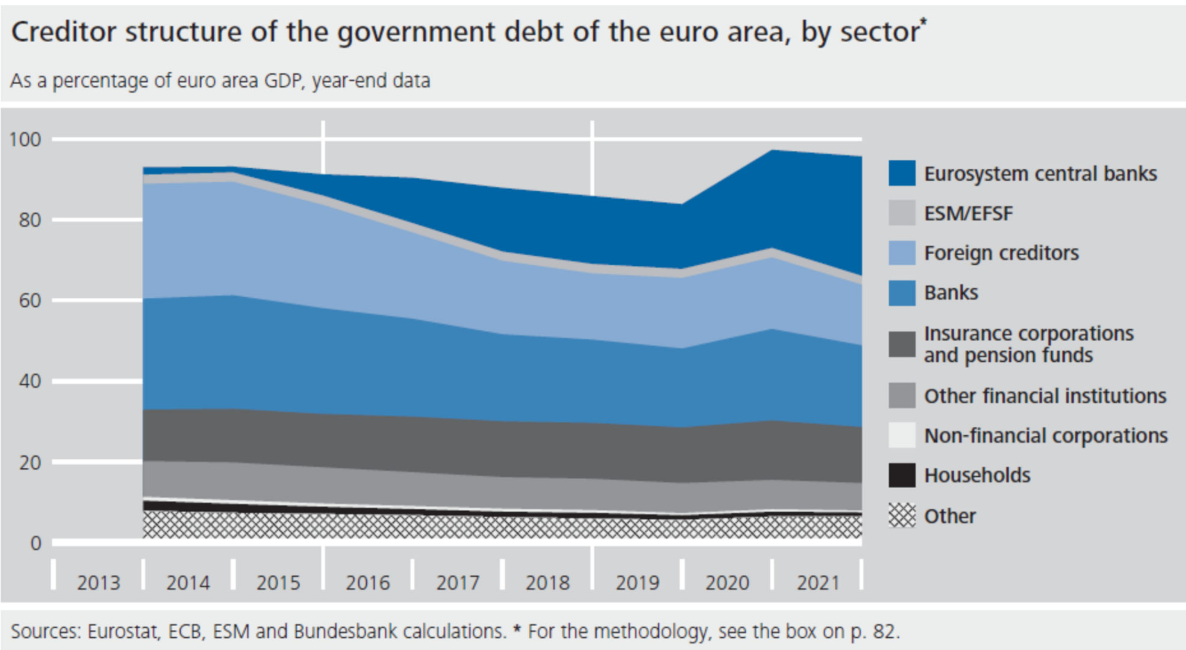
- Introduce risk-adjusted large exposure limits to directly address concentration on home country
- Introduce risk-adequate capital requirements, remove 0% risk weight exception for sovereign exposures,
- Alternatives to large exposure limits include capital requirements for concentration (concentration charges) but they would need to be risk-adjusted.
- Introduce fiscal backstop to SRM
- Move forward with incentive-compatible common deposit insurance if privileged treatment of sovereign exposures has been ended.

Where we stand

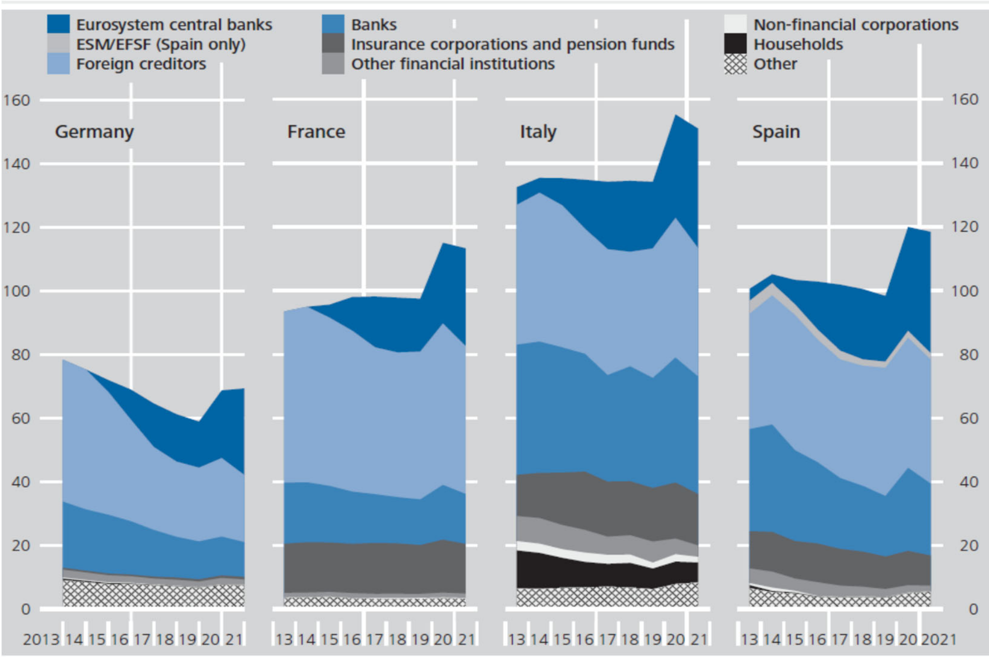
- There has been no appetite for removing privileges for sovereign debt
- Preference for addressing bank problems and resolution on national level
- Zero risk weights on exposures to home country with regard to bank capital.
- Sovereign exposure exempt from large exposure limits
- No European deposit insurance

➔ Not surprisingly, bank exposures to own sovereigns have remained high in spite of large-scale central bank purchases, particularly in high-debt economies

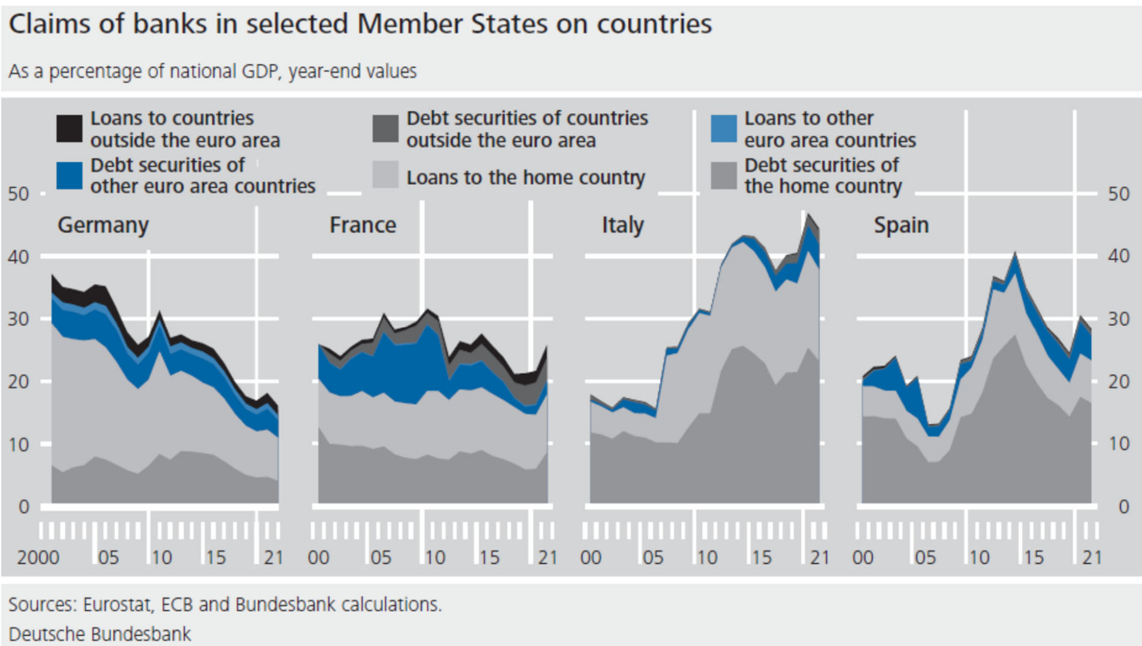
Central banks purchased a large of government debt since 2013, bank‘s holdings declined somewhat (Bundesbank 2022)



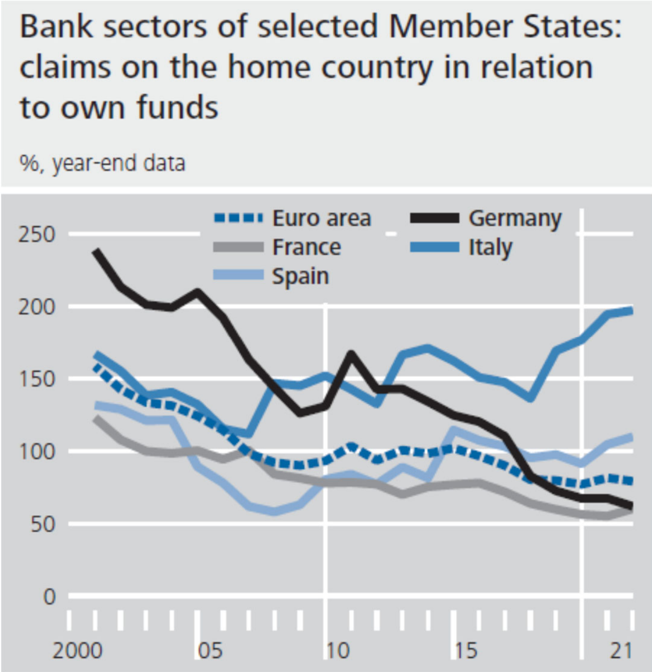
but in some countries, for example Spain and Italy, banks' exposures remain very large (2013 to 2022, in % of GDP)



In Italy and Spain bank holdings of government debt remain much higher than before the global financial crisis



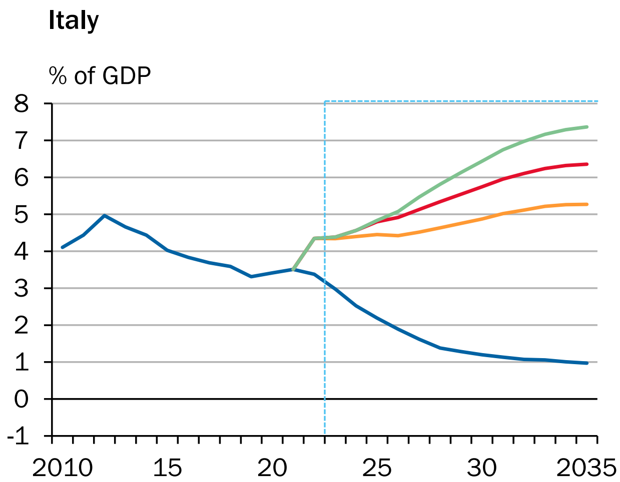
While bank claims on home country in relation to own funds have generally declined in the euro area,

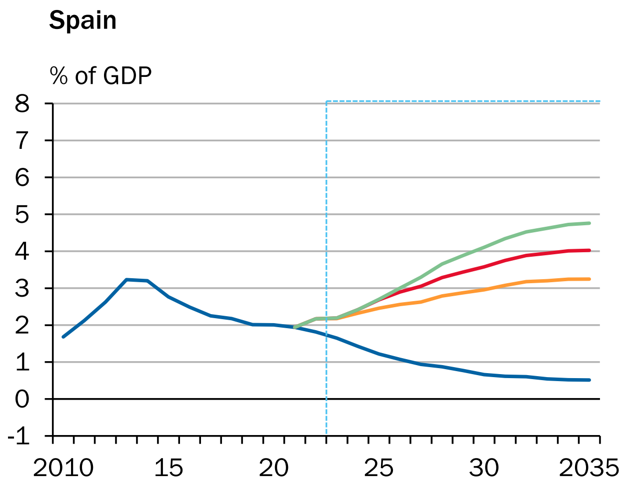


... they have increased in Italy and Spain! Bundesbank 2022.

Italy and Spain also stand out with regard to more recent exposures measures (eurofi 2023).

Interest rates have risen, interest expenditure (in % of GDP) may rise towards levels observed in the debt crisis (Grimm, Nöh, Wieland 2023)





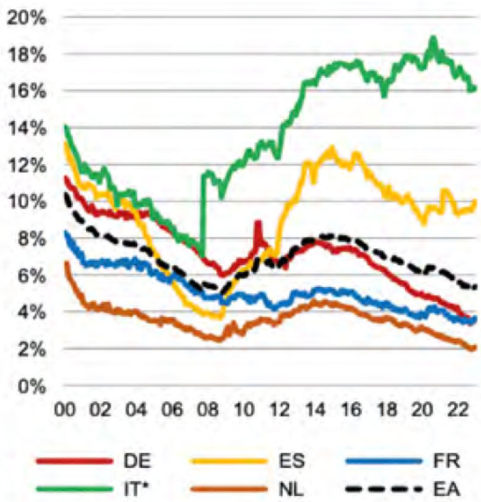
Term structure: August 16, 2021, August 15, 2023, Aug 15, 2023 + 1 PP, Aug 15, 2023 +2 PP

Italy & Spain exceed interest expenditure (% GDP) from crisis years 2012/13 in 2031/32, 2027/28, 2026/27

Extra

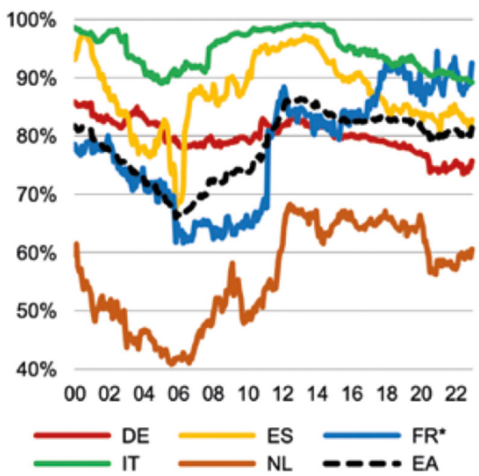
Italian and Spanish Banks stand out in terms of exposure measures relative to home country (Eurofi update 2023)

Domestic sovereign exposure in % of total assets, until December 2022



Source: ECB, Deutsche Bank Research

Domestic relative to total euro area sovereign exposure, until December 2022



Source: ECB, Deutsche Bank Research

** Surge in 2011 due to a statistical reclassification of other euro area bonds*