# Jens Weidmann: Breaking the sovereign-banking nexus

Guest article by Dr Jens Weidmann, President of the Deutsche Bundesbank, entitled "Stop encouraging banks to load up on state debt" in the *Financial Times*, published on 1 October 2013.

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It appears to be another case of the "principle of unripe time" – the notion coined by the late English classicist F.M. Cornford "that people should not do at the present moment what they think right at the moment, because the moment at which they think it right has not yet arrived".

The financial and sovereign debt crisis have underpinned the importance of breaking the disastrous sovereign-banking nexus – in which shaky bank balance sheets degrade the solvency of their sovereigns, and vice versa. A European banking union is an important step towards escaping this deadly embrace. To this end, and to complement the banking union, a reassessment of the regulatory treatment of sovereign exposures of financial institutions is crucial.

The current and incoming regulatory framework implies preferential treatment of sovereign exposures in various forms. While bank exposures to a single counterparty are limited, in principle, to a quarter of their eligible capital, exposures to sovereigns are exempted from that large exposures regime. Sovereign exposures are also privileged by low or zero capital requirements.

Preferential regulatory treatment makes it highly attractive for financial institutions to invest in government bonds – and those of their home countries in particular. During the crisis, this has become more attractive still. The share of euro-area sovereign bonds in total bank assets in the eurozone increased over the past five years by one-third – from 4 per cent to 5.3. And in most countries the home bias, which decreased over the first decade of monetary union, increased again during the crisis.

Average figures mask important differences from bank to bank and country to country. Recent studies, including one by the Bundesbank, find that larger banks, less capitalised banks and banks that are dependent on wholesale funding invest more in sovereign bonds than others. Hence, the more vulnerable banks are, the more they expose themselves to sovereign debt.

Weak banks invest in high-yield sovereign bonds and refinance at currently low interest rates. Such "carry trades" sustain the low profitability of those banks and postpone necessary adjustments of their business model.

The reasons for the increased exposures of banks to their domestic sovereigns may vary: the search for yield, moral suasion, the endeavour to stabilise their own respective sovereigns or simply strategic considerations. In an economy in which the sovereign defaults, banks are likely to default, too. Thus, the domestic banks have an incentive to invest in sovereign's bonds and earn the yield mark-up if things go well. What happens in the event of a joint sovereign-bank default is not relevant for them. This undermines market discipline for governments and reduces their incentive to carry out necessary structural reforms. On the other hand, banks, which can obtain unlimited cash against sovereign collateral from the central bank, are protected from discipline from investors who provide funding.

Large sovereign bond exposures might also harm the real economy. Rises in sovereign risk are transmitted into reduced bank lending. Banks that were highly exposed to strained European sovereign debt have reduced their lending to the private sector.

Thus, the current regulatory treatment is incompatible with the principle of individual responsibility; the market interest rate no longer reflects the riskiness of the investment. I am aware that banks as well as governments are afraid of rising funding costs as a result of ending the regulatory privileges afforded to sovereigns. The argument goes, moreover, that such a regulatory move risks considerable market turmoil. I do not think that this argument should keep us from doing the right thing.

No market participant would judge a French bond to be as risky as a Greek one: the riskiness of each is reflected in their prices. Investors believe that sovereigns differ in terms of riskiness. So no one should be surprised when the regulatory treatment accommodates this fact.

If additional capital requirements for European banks were imposed to cover sovereign exposures, the extra capital would be almost negligible on aggregate – albeit with substantial differences between banks. Other measures, such as the inclusion of sovereigns in the large exposures regime might lead to more substantial repercussions, but these would be manageable if introduced over a transition period – which undoubtedly has to be granted.

When it comes to funding costs for governments, a healthier banking system with better diversification would pose less of a burden on states. The contingent liabilities of the government would shrink which – all other things being equal – would reduce the risk of investing in sovereigns and, eventually lower the sovereign bond yields.

The current regulation’s assumption that government bonds are risk-free has been dismissed by recent experience. The time is ripe to address the regulatory treatment of sovereign exposures. Without it, I see no reliable way of breaking the sovereign-banking nexus.