

“The regulatory treatment of sovereign exposures”

Comments by Graham Bishop on BCBS [Discussion Paper](#)

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This short paper relates solely to the countries that use the euro as their “domestic currency”. By definition, they are in a fundamentally different relationship with the currency in use in their country compared with all other members of say G10 or OECD. The sovereign states of the Eurozone (EZ) issue their bonds in a currency (i) that they cannot control and (ii) that no single government has the power to instruct the Central Bank to lend it currency to repay its bonds.

This is a constitutionally-entrenched difference with all other major countries where the legislator - with public support – has the power to change legislation and require the central bank to provide monetary finance that can be used to redeem the sovereign state’s bond obligations on schedule.

The discussion paper does not appear to recognize this fundamental - and critical – difference in the nature of the obligations of EZ sovereigns and all others.

This difference has not arisen by accident – it was an integral part of the design of monetary union reflecting the economic history of the participants and the preceding decade or more of very high inflation. In a parallel – and not particularly connected – strand of activity, the 1974 Basel Concordat was being converted into the 1988 Basel I Capital Requirements by the central bankers of the world.

Basel I

In this paper, the Committee did go some way to recognising this key difference: *“In considering the role of currency denomination in the treatment of sovereign exposures, the Committee discussed the idea that sovereign exposures denominated in a currency other than that of the sovereign in question are relatively riskier than those that are denominated in the sovereign’s own currency.”* But this is more appropriate for reviewing a foreign currency exposure and entirely misses the point that the euro is indeed the currency used by the sovereign but is **not** the sovereign’s **own** currency in the normal sense of the sovereign being able to control that currency.

Basel I was finalised in 1988 when the concept of economic and monetary union (EMU) was just starting to be discussed seriously. In June 1988, the Heads of State/Government appointed Commission President Delors to prepare a report on how to create the currency part of EMU. This Report was published in April 1989 – so about a year **after** the Basel I language had been finalised – see box below. During the lengthy discussions on ‘Basel’, there was no reason to foresee the creation of EMU and reflect it explicitly. So it was quite rational for the central bankers to frame the ‘national currency’ definition only in economic concepts that they had used for decades.

The Delors Report was actually written by the EU’s central bank governors but there is little evidence that they foresaw a possible clash of inconsistent definitions in the event of an economic and political calamity of a type that had not befallen major countries not seen since the 1930s – half a

century, and a World War, before. But they did go on to play a major role in designing the relevant parts of the Maastricht Treaty.

		Annex 2
Risk weights by category of on-balance-sheet asset		
0%	(a)	Cash ¹
	(b)	Claims on central governments and central banks denominated in national currency and funded in that currency

Maastricht Treaty

The political authors of the Treaty were determined to ensure that EMU could not turn into a political disaster by imposing financial burdens on unwilling states. They crafted the No Bail-Out Rule to ensure this did not happen – see box below. The result was – as intended – that a bank taking a credit exposure to an EZ sovereign had to rely directly on that State’s creditworthiness flowing from its own budgetary and debt position – as with any private sector creditor who cannot create the money to repay the debt.

The No Bail-Out Rule: TFEU Article 125

1. The Union shall not be liable for or assume the commitments of central governments ... A Member State shall not be liable for or assume the commitments of central governments...

Of course, the Treaty incorporated economic governance requirements to enforce sound fiscal policy. That would be the true ‘guarantor’ of the credit quality. History has shown these policies were too weak and the recent crisis has forced a major strengthening of oversight. However, the Treaty signatories were quite clear that they intended this EMU to be quite different from anything ever seen before – with the logical consequences for sovereign credit quality. But the potential consequences were not recognised at the time – or were swept under the carpet.

As history is replete with examples of governments cheating, the Treaty-makers sought to cut off all such avenues. The No Monetary Financing Rule – see below - prevented sovereigns from falling back on emergency loans from the central bank – in effect, the printing of money to pay public debts. This was the key action that removed the risk-free status of sovereign debt in nominal terms. In the ‘old days’, governments had simply turned on the printing press so that banks got their money back on the due date. The nominal value was risk-free, but the resulting inflation made the ‘real’ value very risky indeed over time.

The No Monetary Financing Rule: TFEU Article 123

1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as ‘national central banks’) in favour of Union institutions, bodies, offices or agencies, central government... shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.

The ‘belt and braces’ approach was continued by entrenching the Central Bank’s independence in the Treaty itself – see box below. This made the EZ system’s independence qualitatively different from any other major central bank at the time. The TFEU can only be amended by **unanimous** agreement of all the Member States, and some of them might require a referendum to make such a change. So any action to remove the deeply-entrenched provisions that took control of money away

from the EZ sovereigns would be lengthy, ponderous and may not even happen at all. That is hardly a scenario that enables bank supervisors to declare that sovereign debt is by definition risk-free. The EZ undertook a major constitutional process for the express purpose of making it risky – except to the extent that sound economic policies should put disasters beyond the realms of possibility.

The Central Bank Independence Rule: TFEU Article 130

When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties ... neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions ...and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.

My Objections to the proposed “No privileged access to financial institutions” Rule

To make the situation absolutely iron-clad, the Treaty makers finally incorporated a prohibition on governments writing financial regulations that preferentially channel the nation’s savings into sovereign debt – see box below.

The No Privileged Access Rule: TFEU Article 124

Any measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments ... to financial institutions, shall be prohibited.

This author wrote several papers for Salomon Brothers while the Treaty negotiations were continuing and pointed out explicitly that the “0% risk weighting” rule in Basel I was by definition giving governments “privileged access” to the financial system. Perhaps the seminal paper was “**The Creation of an EC “Hard Money” Union**” published in July 1990 ([link](#) to photocopy version). However, debt managers became alert to the possible risks and I am told on very good authority that the phrase “*not based on prudential considerations*” was inserted into the text to ensure my critique was frustrated. **In the Great Financial Crash, the fears expressed during the Treaty negotiations indeed crystallised.**

What can be done?

There seem to be two basic options:

1. The European Union could amend the TFEU to remove the phrase about “prudential considerations” but that would require the full panoply of the heavy process of changing the Treaty and would certainly open the door to all manner of other, unrelated requests that would make it a very difficult thing to achieve.
2. The language in the Basel agreements could be amended explicitly to carve out EZ states from the existing definition of domestic/national currency. The risk treatment could be akin to that of borrowing in a foreign currency but that is not an exact parallel as there is only risk of a currency movement against the sovereign issuer if it leaves the euro. A carve-out would leave all other states in exactly the same situation as today.

The Discussion Paper points the many proper functions of government debt in providing safe liquidity to the financial system. The EZ still needs those and my proposal for a Temporary Eurobill Fund ([Link to 30 FAQs](#)) would deliver the most liquid and safest asset in the EZ so that would surely be seen as the EZ’s least-risk asset.