Banks / Financial Regulation

Sovereign debt in European banks

Expansión (Spain)

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European banks hold sovereign debt on their balance sheet for multiple reasons. Firstly, sovereigns are eligible in order to comply with liquidity requirements. In addition, they can be used as collateral in the private repurchase markets ("repo") and to obtain funds from the central bank. They are also essential instruments in the management of bank balances and maturities. With respect to bank profitability, the yields on sovereign debt are included within interest margins, which gain particular relevance in times of low economic growth (the "flight to safety" effect occurs when banks increase their preference for risk-free assets during times of crisis). However, the gains that can currently be obtained from sovereign debt are limited, considering that yields are at a minimum of ten years in most European countries, a situation that could potentially be prolonged given the low level of official ECB rates.

In the period from June 2017 to June 2018, consolidated sovereign exposures for a sample of fifteen European countries increased by 3%, reaching the maximum since December 2016. The increase has been underpinned by non-euro area banking systems, as the euro area systems slightly decrease their exposures (peripheral systems remain steady and core systems show a slight decline). In addition, several systems in the euro zone have shown a gradual decline in the volume of consolidated sovereign exposures over the last five semesters, including Greece, Germany and the Netherlands. However, during the first half of 2018, banks reinforced their consolidated sovereign portfolios, with an increase of 9% on a weighted average for the total sample. All banking systems considered, showed an increase in the first half of 2018, both euro area systems (core and peripheral), as well as non-euro area systems. Only Greece, Austria, Germany and the Netherlands showed decreases in the first half of 2018.

Regarding the volume of exposure to local sovereign debt, in the first half of 2018 this figure increased by 6% for the sample considered. The banking systems of the euro area (core and peripheral) and non-euro area systems showed increased exposure to the local sovereign. In fact, only four countries show a decrease during the period (Greece, Austria, Germany and Norway). However, since December 2017, the weight of local sovereign debt over the total sovereign portfolio of banks has fallen by three percentage points, up to less than half of the total as of June 2018. This decrease is derived from the fact that, during the first half of 2018, the increase in consolidated sovereign exposure was higher (9%) than the increase in local sovereign exposure (6%). The fact that banks' exposure to the local sovereign accounts for less than half of the consolidated portfolio reduces the risk of sovereign-national contagion ("doom loop"), which occurs mainly through direct exposures of the banks to sovereign debt. In terms of banking systems, core and peripheral systems have a weight of local debt above half of the consolidated sovereign portfolio, while non-euro area systems account with less than a third of total sovereign exposures. Thus, the culmination of the banking union is essential, and, jointly with the creation of a "safe asset" at European level, would also strengthen the reduction of the sovereign-banking nexus.

As of June 2018, the exposure to the local sovereign is 114% of the Tier 1 or going concern capital for the analysed sample (134% for the core systems of the euro area, 136% for peripheral systems, and 55% for non-euro area systems). Exposure to local sovereign in percentage points of Tier 1 increases during the first half of 2018 in all of them. As of June 2018, eight countries have a greater exposure to 100% of Tier 1 (Italy, Portugal, Spain, Belgium, Finland, France, Germany and Holland). Therefore, there are no significant differences between the core and peripheral banking systems in relation to the high exposure to the national sovereign.

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