European Safe Bonds Are Unlikely to Attract Investment

By Jean Dermine , INSEAD Professor of Banking and Finance

The European Commission's proposal for European safe bonds (ESBies) will not entice low-rated banks away from holding risky domestic government debt.

Heads of state at the European Union summit at the end of June are expected to discuss the proposed creation of "sovereign bond-backed securities" to increase the stability of the European banking union.

The idea is that a portfolio of government bonds issued by European countries will be pooled in a portfolio and transformed into securities with standard securitisation techniques, the sovereign bonds-backed securities (SBBS). The senior bonds (referred to as European safe bonds, ESBies) will be equivalent to safe German bonds. The implementation will be demand-led with banks expected to invest in these safe, geographically diversified bonds, instead of holding risky domestic government bonds. If successful, this would weaken the so-called "doom loop" between sovereign borrowers and banks.

But will there be a demand for ESBies? We argue that banks in economically weaker EU countries are not likely to invest in ESBies. I presented two new explanations for that in my research paper entitled **"Banks' Home Bias in Government Bond Holdings: Will the Supply of ESBies Create its Own Demand?"**.

They complement known factors behind banks' preference for risky domestic government bonds – risk shifting and the gamble for resurrection – which I will discuss later in this article.

Sovereign-based cap and "bank tax"

First, banks in economically vulnerable countries, such as Greece, Italy or Portugal, are subject to a sovereign-based cap on their credit rating. It limits the extent to which their cost of borrowing would fall even if they diversify away from risky domestic government debt to safer assets such as ESBies.

Although credit rating agency Standard & Poor's (S&P) no longer limits a company's credit rating from exceeding that of its sovereign host's, it recognises that companies are vulnerable to their host country's economic environment. Banks are perceived as highly sensitive to country-related risks because they are subject to domestic fiscal policies and regulation. As such, the number of the notches that a bank's credit rating can exceed its host country's sovereign foreign currency bond rating rated 'B' or higher is restricted to two by S&P.

Banks with low-credit ratings are unlikely to invest in safe assets because the return on these assets is lower than their cost of borrowing, thus hurting their profitability.

The following example illustrates the reasoning of banks operating in low-rated countries. A large South African bank concluded that the cost of switching from holding risky domestic South African bonds to United States' debt with a higher credit rating would outweigh the benefits. The bank believed it would not be adequately rewarded for reducing the riskiness of its assets.

The second explanation is the probability of a tax imposed on solvent banks by a country in economic crisis, in an attempt to shore up national finances. After the global financial crisis, a tax was levied on banks in 14 European countries to finance budget deficits. In Australia, the government levied a new tax in 2017 on its five largest banks. So, in deciding whether to invest in safe bonds or risky government bonds that carry higher yields, banks will take into account the likelihood that a “bank tax” could be levied on solvent banks.

In the absence of a sovereign economic crisis, banks can reap high returns from holding risky government bonds. Once a crisis strikes, however, banks holding risky bonds will fail and avoid having to pay the “bank tax”.

Tackling banks’ yen for domestic government debt

The paper highlights the difficulty of creating a European banking union while fiscal policies are national. A demand-led approach is unlikely to work as banks from low-rated countries are not likely to invest in safe bonds. So, what can be done to address this preference for risky domestic government bonds? I believe the Basel Committee on Banking Supervision will have to enforce the large exposure rule in stopping banks from lending more than 25 percent of their Tier 1 capital to a single counterparty.

In addition, the Basel Committee may decide to enforce capital regulation on holdings of risky domestic government bonds which are currently exempted from such regulations. The debate will be fierce, as countries with large public debt find it convenient to place government bonds with domestic banks.

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