18th Annual International Conference on Policy Challenges for the Financial Sector

"Competing priorities in an evolving industry"

Can regulatory changes mitigate the sovereign-bank nexus?

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The crucial role of sovereign debt for banks

For banks to perform their main function, the provision of credit to the economy while managing risks, there are good reasons to hold sovereign debt…

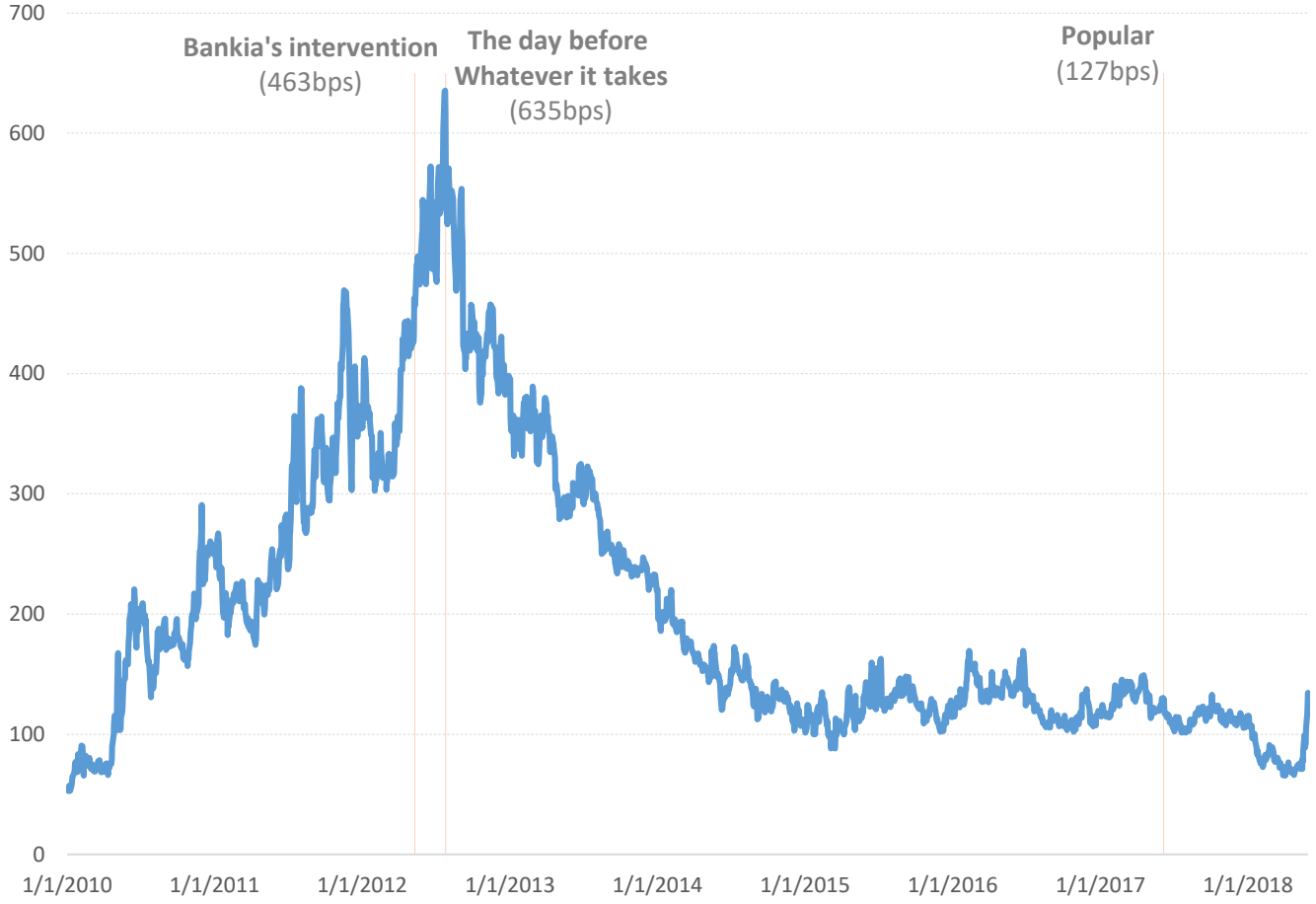
….When authorities are considering to change the regulatory treatment of the sovereign debt, we should consider:

- the incentives and implications this would impose
- if there are alternatives to the sovereign debt and whether those are needed and which they could be.

The new resolution framework, although still incomplete, has helped to break the link

Spanish sovereign spread in the two main bank resolutions

(10y bond spread against 10y German bond)

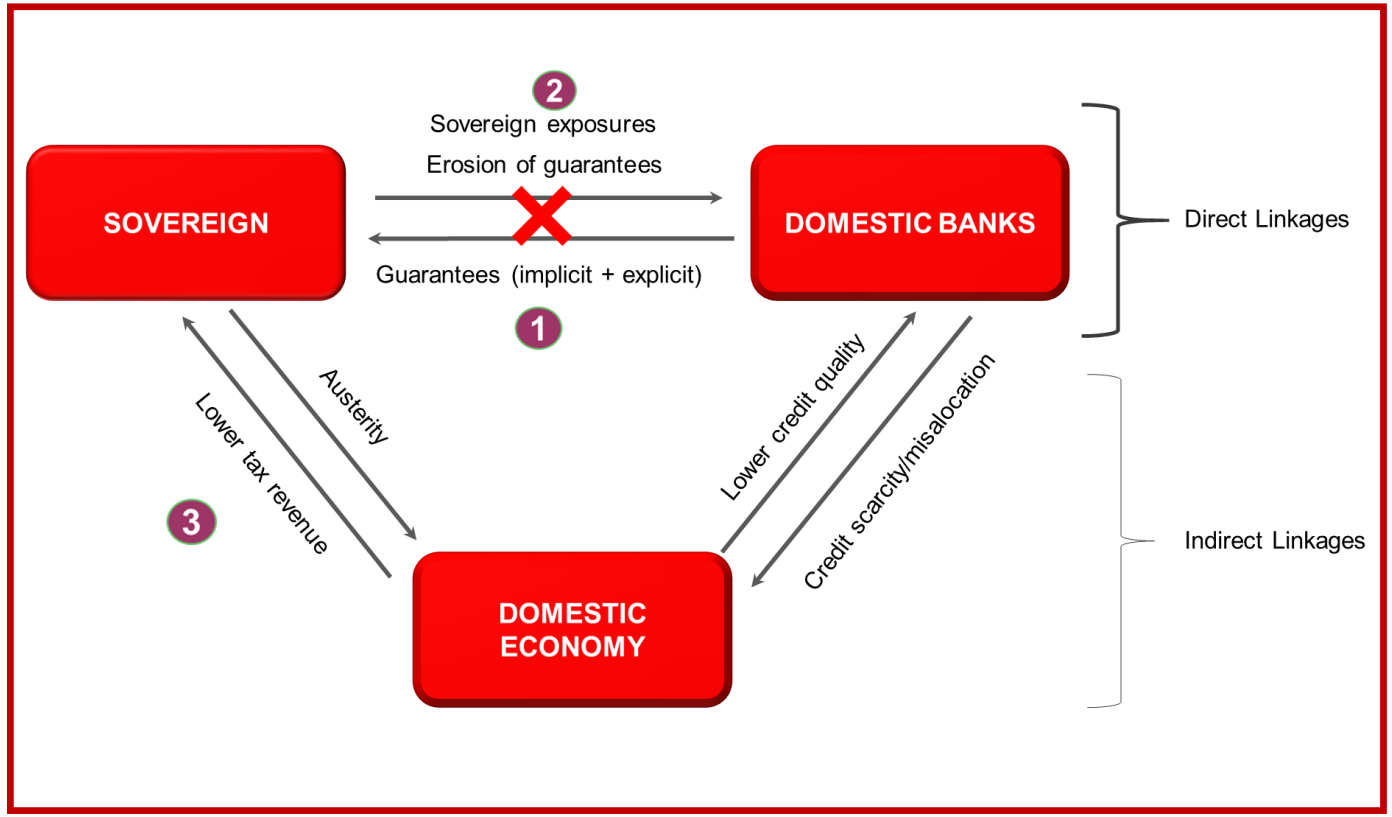


Source: Thomsom Reuters

- Banking crisis (e.g. Bankia) used to have a direct impact on the sovereigns.
- The resolution of Banco Popular had no impact (even slightly positive) on the Spanish sovereign spread.

Sovereign-banks nexus: Where to act?

The "vicious" circle



Source: Schabel, I. and Verón, N. (2018). "Completing Europe´s Banking Union means breaking the bank-sovereign vicious cycle". *VOX CEPR´s Political Portal*.

✗ 1 The new resolution framework addresses the TBTF

✗ 2 CDS premia of banks were not correlated with their holdings of public debt.

✓ 3 The "**macro effect".** CDS premia of non-financial firms and banks were impacted in a similar way when the sovereign credit rating of the country severely deteriorated.