Credit

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Heading for the Great Repression (ii)

Why financials will be captive buyers of sovereign debt

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- **Propping up periphery sovereigns –** As foreigners exit government bond markets in the European periphery, domestic banks, propped up by ECB liquidity, have stepped in to take up the slack. Spanish and Italian banks have covered not only the sovereign funding requirement, but also foreign net selling in recent months.

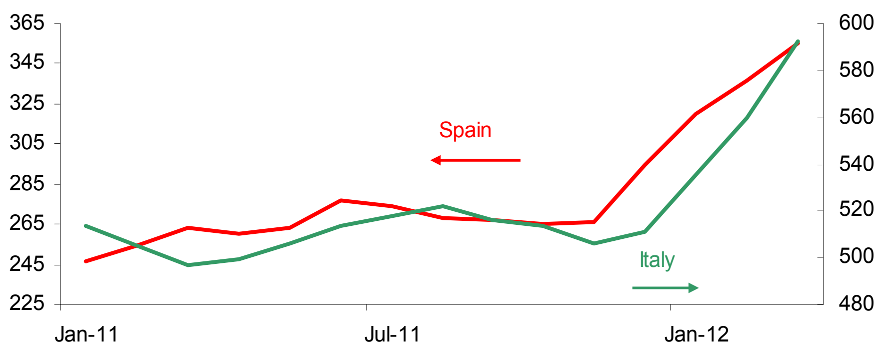
- **Holdings of sovereign debt rising globally –** But the trend started long before the LTROs, and banks in the UK and the US have also been raising their holdings of government and agency debt. Longer-term, we reckon the temptation to create captive demand will prove irresistible to governments facing a difficult funding environment.

- **Using regulation to find captive demand –** Financial regulation has long favoured government debt, and recent changes have in some respects made the bias even more pronounced. The definition of the liquidity coverage ratio under Basel III, and the exclusion of sovereign debt from the capital requirement under Solvency II, are two examples.

- **Bank bonds: a more binary investment –** The growing interconnectedness between banks and sovereigns, and the effective subordination of unsecured bank debt, makes investment in bank bonds a more binary proposition. That speaks for holding either bonds with security or hybrid capital, where the subordination risk is already priced in. Relatively speaking, we believe the risk to senior is underpriced.

- **Demand a sovereign premium –** Greek PSI may not have led to the bank bail-ins the market had feared, but we would be careful about extrapolating on a sample of one. We prefer higher beta, but systemically important banks in low risk sovereigns over banks trading inside or flat to their higher risk sovereigns.

Figure 1. Spanish & Italian bank holdings of Eurozone sovereign debt, €bn



Source: CIRA, ECB

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Heading for the Great Repression (ii)

Over the last couple of decades we have come to take the free movement and allocation of capital for granted. Yet a quick glance back in history shows that state intervention in financial markets, and the banking sector in particular, tends to move in cycles. And most of the time intervention has been much heavier.

As governments struggle to restore fiscal balance, the old, well-known tools of financial repression are reappearing in an attempt to reduce the real burden of debt through negative real yields.

In "Heading for the Great Repression: Investing in a world of government-suppressed real yields", we argued that financial repression might well be positive for risk assets in its early stages, but by prolonging imbalances and introducing new distortions it is likely to be a long-term negative.

Here, we explore the role banks and financial institutions more broadly play in the implementation of that low interest-rate policy, and the impact on their bondholders. Above all, we think the temptation to find domestic 'captive buyers' will once again prove irresistible to policymakers facing a difficult funding environment. This is particularly the case in Europe, where a weakened, vulnerable banking sector is itself reliant on sovereign support.

First, we show that bank holdings of domestic sovereign debt have risen sharply – not just in the periphery after the LTROs. A longer-term trend seems to be underway. Then, we analyse some of the regulatory incentives in Basel III and Solvency II to buy government debt. Finally, we look at the impact on bondholders.

We conclude that financial repression of financial institutions is likely to increase over the coming years, leading to ever greater interdependencies with sovereigns. The distortions created could sow the seeds for even bigger crises in the future, if the time bought is not used prudently.

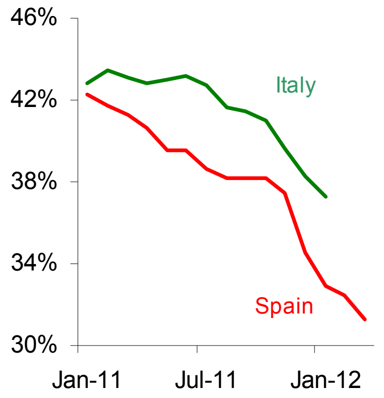
Bondholders will have to weigh up the short-term benefits against the long-term risks. Bail-ins and bank collapses are in our opinion less likely when banks are funding sovereigns. Conversely, pinning their colours to sovereigns could leave banks with losses extending much further up the capital structure, if the burden of sovereign adjustment proves politically unmanageable. The increasingly junior position of senior unsecured bank bondholders leaves them particularly exposed. We prefer a barbell of securitized and hybrid debt.

Find a captive audience when markets don't listen

One of the biggest paradoxes in financial markets today is that government bond yields in most countries are at historic lows, even though sovereign fundamentals are arguably the worst we have seen them since the post-war reconstruction.

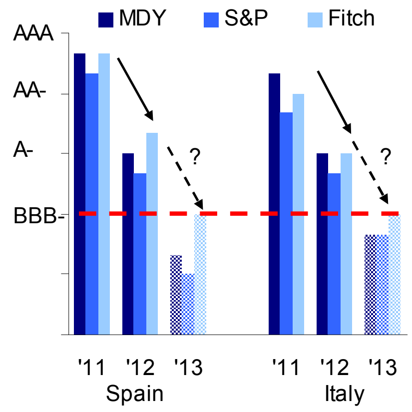
Obviously, from a policymaker's perspective, low yields are paramount to ensure debt servicing sustainability. In our first piece on financial repression, we argued that central bank intervention has been key to keeping yields down. However, banks and other financial institutions also play a crucial role. Nowhere is that more pertinent than in Europe.

Figure 2. Proportion of government debt held by non-residents



Source: CIRA, Banca d'Italia, Treasury of Spain

Figure 3. Rating changes over the last year with extrapolation



Source: CIRA, Bloomberg

Who really wants to buy more periphery sovereign debt?

Despite policymakers' best efforts, natural demand for the growing volume of periphery sovereign debt is proving elusive. For example, from June 2011 to January 2012 the proportion of foreign holders of Italian government debt fell from 43% to 37% - a drop of €100bn. From June 2011 to March 2012 the proportion of foreign holders of Spanish government debt fell from 40% to 31% - a drop of €32bn (Figure 2). We doubt those trends will reverse any time soon. If anything, they are likely to continue[1].

Many new funds now exclude Italy and Spain from their benchmarks, and fund managers are contemplating similar exclusions from their existing mandates. Indeed, some funds have entirely abandoned the traditional way of weighting benchmarks by the (duration-adjusted) notional amount of debt outstanding. They are creating benchmarks weighted on fundamentals and growth prospects instead. In effect, they are moving away from a framework that forces them to hold most exposure to the most indebted sovereigns to a framework that encourages them to hold exposures that have the best prospects. European periphery sovereigns don't seem very likely to benefit in our view.

Rating agency downgrades also play an important role. Already, we have seen Greece and Portugal drop out of the conventional sovereign benchmarks.

Neither Italy nor Spain is currently being reviewed by any of the three major rating agencies. But that was no different a year ago and since then both countries have been cut by between 3 and 5 notches by all agencies.

If the rating agencies were to keep downgrading at the pace they have done over the last year, then both sovereigns would be junk with two agencies and BBB- with the third in twelve months. That implies being out of, or literally a whisker from falling out of, the indices (Figure 3). Is that so unrealistic? The markets are already pricing both sovereigns wider than many BB-rated credits.

When Portugal dropped out of the index in January, the 10yr yield spiked as much as 5% – presumably to a large extent due to forced selling. Considering that Italy and Spain constitute one third of a European sovereign bond benchmark, the mere prospect of their departure from benchmark indices would likely have a much, much bigger impact on markets. It is very hard to envisage that any private investor would willingly step forward as the marginal buyer, if either sovereign gets downgraded to the mid- to low-BBB area.

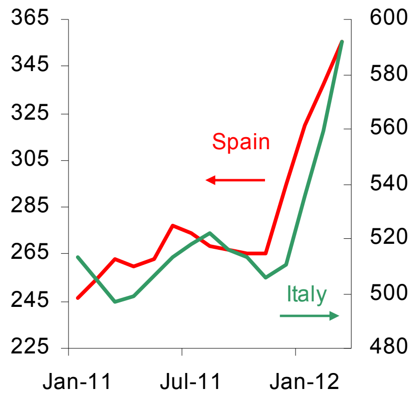
Banks providing a fig leaf for the ECB

As we saw in H2 2011, the gradual withdrawal of private investor demand can very quickly accelerate. When there is no lender-of-last resort (or rather, a buyer), it is rational for an investor to sell before everyone else does if he fears forced selling.

Conventionally, the central bank takes that role. But in the Eurozone, it is more complicated. Broad QE would not currently find support in all member states. Parts of the ECB are inherently uncomfortable with the SMP – because it comes with no conditionality and because it opens up the ECB to those who see the SMP as a violation of, if not the letter then the spirit of the EU Treaty prohibition of monetary financing.

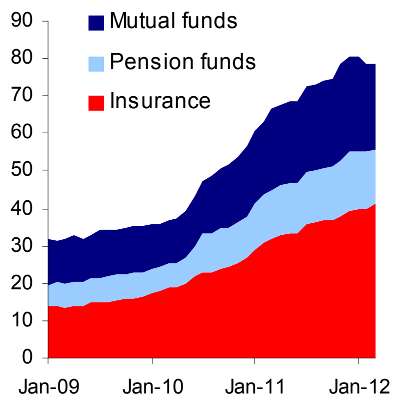
[1] See 'Tracking the flight from peripherals', M. King, 21 May.

Figure 4. Spanish & Italian bank holdings of Eurozone sovereign debt, €bn



Source: CIRA, ECB SDW

Figure 5. Domestic holdings of Spanish government debt, €bn



Source: CIRA, Haver

The LTROs not only avoided a serious bank funding crisis in Europe; they also neatly circumvented that issue – incentivising banks to buy more government bonds was a key objective. Indeed, then President Sarkozy explicitly encouraged banks to put on the 'sovereign debt carry trade' when the first LTRO was announced.

Moreover, the ECB has argued that the LTROs provide them with an easier exit than outright QE.

For a while, the LTROs had a very tangible impact on Spanish and Italian yield curves, but most of the benefit appears to have reversed out again. Yet, it would be wrong to regard them as a failure– in a counterfactual scenario we reckon yields would have been far higher.

More importantly, the impact the LTROs have had on bank demand for domestic sovereign debt has been very tangible. Between November and March, Spanish and Italian banks added €90bn and €86bn of Eurozone government debt, respectively (Figure 4). The vast majority of this debt is likely to have been domestic. These amounts exceed the net sovereign funding requirements over the same period, so banks were in effect funding not only the net issuance but also the foreign selling.

Other domestic financial institutions have also been buying in some countries – albeit on a smaller scale. For example, Spanish asset managers and insurance companies have increased their holdings of Spanish government bonds by almost €50bn over the last 3 years (Figure 5). However, there is no discernible shift in their demand following the LTROs.

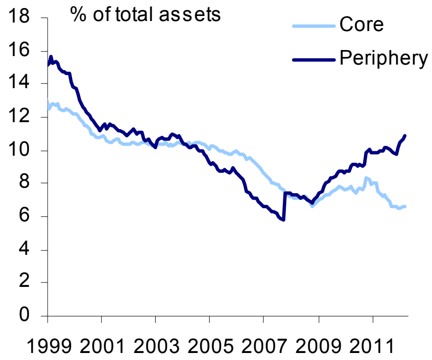
Sovereign debt demand in a global context

Bank demand for domestic sovereign debt may be most apparent in the European periphery. However, we think it would be wrong to assume that it was all caused by the LTROs. The rise in periphery bank holdings of domestic sovereign debt started long before.

Figure 6 shows bank holdings of government bonds and loans[2] as a percentage of their total assets for banks in the core and in the periphery. For periphery banks, a break in the 10-year declining trend is very apparent already in 2009. In fact, the exposure as a proportion of the total assets on balance sheet has almost doubled from the lows. This is not just a function of the recessionary / low growth environment – in 2001-02 there was no increase in sovereign exposure.

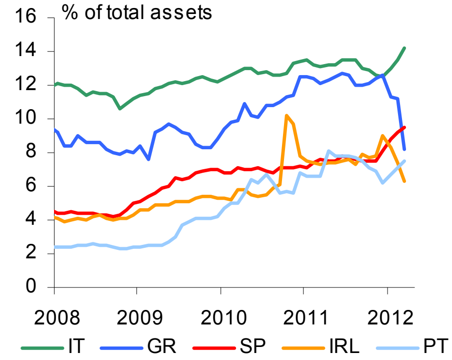
[2] Domestic and foreign

Figure 6. Core and periphery bank holdings of sovereign loans & bonds



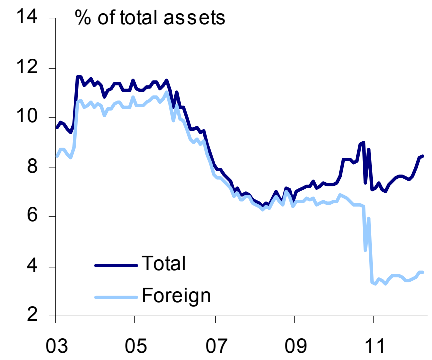
Source: CIRA, Haver Analytics, ECB

Figure 7. Bank holdings of sovereign loans & bonds (by bank domicile)



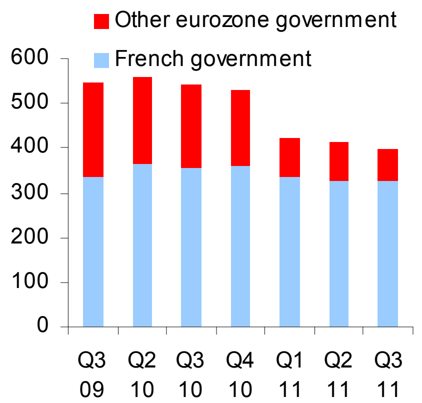
Source: CIRA, Haver Analytics, ECB

Figure 8. Sovereign exposure of Irish banks, foreign & total



Source: CIRA, Haver

Figure 9. Sovereign exposure of French banks, foreign & total



Source: CIRA, Banque de France

The increase relative to balance sheet size is broad based across all periphery countries (Figure 7). Even in Greece, absolute holdings were stable despite the sharp declines in market prices and rapid shrinkage in balance sheets – until PSI brought the notional value of holdings down again. In Ireland, it is notable how the partial nationalization of several large banks appears to have coincided with a shift from foreign to domestic sovereign exposure (Figure 8).

At first glance, banks in the core appear to have continued to reduce their sovereign debt exposure in recent years. But judging by French data (Figure 9), what's really happening is that banks are returning home – their holdings of French government debt are largely unchanged, but holdings of government debt of other Eurozone sovereigns had shrunk by €143bn or 67% already by the end of September 2011. In all likelihood, the exposure has decreased further since, while it wouldn't surprise us if holdings of domestic government debt have been increasing in recent months.

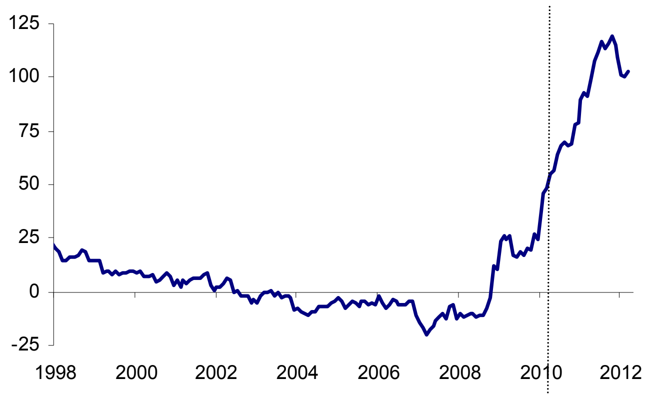
UK and US banks are also buying

Even outside the Eurozone there is strong evidence of a reversal of past trends.

UK banks have traditionally held very little exposure to the domestic public sector. But over the last couple of years, UK banks have increased their holdings of gilts by more than £100bn. That implies that they have bought up about 15% of the net increase in outstandings in recent years.

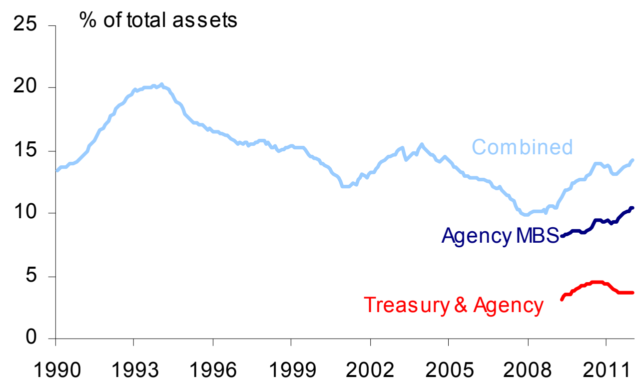
US commercial banks also have comparatively low holdings of US Treasuries, but their exposure to agency mortgage-backed securities has been rising steadily over the last few years. Relative to total assets again the shift perhaps doesn't look dramatic, but in dollar amount the $700bn increase since the beginning of 2008 can hardly be described as negligible.

Figure 10. Gilt holdings of UK banks, £bn



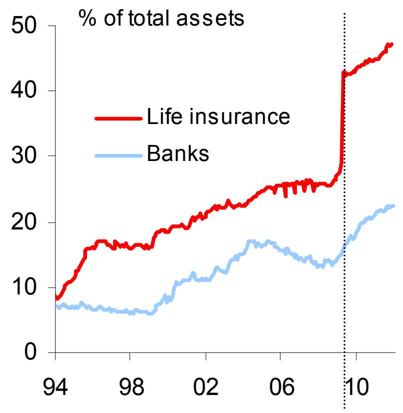
Source: CIRA, Haver Analytics

Figure 11. Domestic public-sector exposure of US banks



Source: CIRA, Haver Analytics

Figure 12. Dom. public-sector bond holdings, Japanese banks & insurance



Source: Citi Investment Research and Analysis

The Japanese experience suggests that bank ownership of sovereign debt can go much further, if need be. In Japan, exposure to the sovereign as a proportion of total balance sheet has been rising for more than a decade for both domestic banks and life insurance companies.

For example, after the reclassification of Japan Post Insurance to the private sector in 2009, exposure to the Japanese sovereign now constitutes more than 45% of the assets of the life insurance sector. In 1994 it was just 10%. More than 20% of bank assets are sovereign debt – significantly higher than in Europe and the US.

If sovereigns in Western Europe and the US struggle to stabilize their deficits as in Japan, then the proportion of sovereign debt on the balance sheets of financial institutions will probably continue to climb over the coming years.

So this increase in domestic government debt on bank balance sheets is broad based. Next, we will look at the underlying drivers.

Deploying the tools of financial repression

Ask the simple question: why are banks buying sovereign debt when yields are either near record lows, or perhaps more interestingly, when foreign investors are pulling out?

Of course, their demand could reflect that banks have merely become risk averse and/or have struggled to put the money to more profitable use on waning loan demand. But it seems unlikely that these are the only factors, given the stated objectives of many banks to shrink balance sheets.

Our impression from conversations with people working in both banks and other financial institutions in the periphery is that it is a combination of factors. In some cases, they feel they have a better handle on the domestic situation than foreigners. However, more worryingly, domestic sovereign debt is also frequently bought on arguments ranging from a need for high yields to meet funding costs, or “we’re in the same boat as the sovereign anyway”, to outright "pressure from above".

It's not that there is a 'grand conspiracy' among policymakers to repress the financial system. Yet the necessities of dealing with a financial crisis and, in many cases, twin deleveraging of the public and private sectors, have shifted political priorities.

During the Great Moderation, strong and stable growth, facilitated by solid credit growth, permitted a relaxed policy attitude towards markets. However, an environment where the credit multiplier is dropping, and the desire to save/pay down debt is impeding growth, requires a very different approach involving a mixture of carrot and stick.

The LTROs discussed above are one example. On the one hand, both bond and equity markets enjoyed the medicine initially. For a while everyone was a winner. But to our minds it is still a (heavily sweetened) form of financial repression given the pressure banks were under from policymakers to support periphery debt issues.

Banks have ended up buying bonds at yields where they would happily have sold them only a few months prior. If some sovereigns have solvency issues (even long-term), then encouraging banks to buy more debt is not ultimately in bondholders' and shareholders' interests. Markets have rightly reduced systemic risk premia, reflecting a reduced risk of (imminent) default, but for bondholders in periphery banks the expected loss *given* default has risen.

Regulation – buy my debt, and I'll make it worth your while

Yet in a broader sense, the principal foundations required to make banks and other financial institutions captive buyers lie in financial regulation, through a combination of incentives and restrictions.

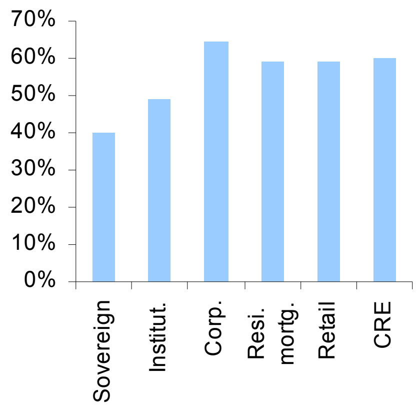
In Japan, for example, regulation hasn't required banks to hold capital against domestic government bond holdings. Conversely, it has excluded even currency-hedged foreign bond exposures from being counted as part of banks' required liquidity holdings. The incentive that creates is obvious.

Basel isn't watertight on sovereign risk weights

The Basel framework, too, has given preferential treatment to sovereign debt. Under Basel I, OECD sovereign debt was 0% risk-weighted. With Basel II, only double- and triple-A rated sovereigns maintained that status under the standardized approach, and the internal-ratings-based approach required banks to apply risk-weights based on estimated probability of default and loss given default.

However, crucially, the rules left discretion over the risk-weighting of sovereign debt denominated in national currency to national regulators[3]. Under the Capital Requirements Directive (CRD), which implemented Basel II in Europe, 0% risk-weights on domestic currency debt of member state sovereigns were still permitted.

Figure 13. Banks using IRB under 2011 stress test



Source: CIRA, "Sovereign risk in bank regulation and supervision: Where do we stand?', H. Hannoun, BIS

Moreover, domestic regulators may within certain limitations permit banks to 'cherry pick' whether to use the standardised approach for some assets, including sovereigns, and the IRB for others. Not surprisingly, perhaps, only 36 out of 90 banks that participated in the EBA stress test last year used the IRB for sovereign debt, compared with 58 on corporate debt[4] (Figure 13).

The 'incremental risk charge' on all trading positions, introduced with Basel 2.5, does include government debt. But according to the IMF, only 12% of European bank sovereign debt exposures are on the trading book[5]. The bulk still lies in the banking book.

As Basel II has never fully been introduced in the US, the treatment of OECD sovereign risk there is still based on the 0% risk weight under the old Basel I rules. If anything, the sovereign privilege in the US looks set to become more entrenched, not less: the single-counterparty exposure limits under the Dodd-Frank reforms specifically exclude the US government and its agencies, but not foreign sovereigns or state and local government.

Basel III does increase the onus on large banks to assess creditworthiness on a more comprehensive basis. But when it comes to sovereign debt on the banking book, regulators can still choose to permit 0% risk-weightings on domestic local currency debt. To alter that in Europe would require a change in the next iteration of the CRD. We doubt that will be politically feasible in the current environment.

Moreover, any reduction in the incentive to hold government bonds through risk weights is probably more than offset by the introduction of liquidity requirements with Basel III, specifically through the definition of 'highly liquid assets' in the Liquidity Coverage Ratio.

[3] 'Is sovereign risk properly addressed by financial regulation?', Danièle Nouy, Financial Stability Review #16, April 2012, Banque de France.

[4] 'Sovereign risk in bank regulation and supervision: where do we stand?' Hervé Hannoun, BIS, 26 October 2011

[5] IMF Global Financial Stability Review, September 2011.

These assets are split into two "levels". Level 1 consists of cash, central bank reserves and 0% risk-weighted government bonds. Level 2 consists of double-A rated corporates, covered bonds and 20% risk-weighted sovereign debt under Basel II. Level 2 assets are subject to a 15%+ haircut and, more importantly, limited to 40% of the total. As such, while the LTROs have provided banks with plenty of central bank reserves and a BIS study found that banks hold less than 40% of liquid assets in level 2 instruments, it is hard to argue that the LCR isn't providing an additional incentive for banks to raise their sovereign debt holdings.

It would be misleading to argue that the Basel regime is a deliberate attempt at financial repression. As often happens with regulation, it has in a number of respects been drafted to address the last crisis rather than the next one. And in fairness, over the various iterations there has been a general move towards eliminating the risk-free status of sovereign debt. But despite good intentions, to date the Basel rules have not been watertight enough to prevent considerable slippage in implementation. At the European level, de facto risk charges on sovereign debt – even at much lower ratings – have remained very low compared to many other assets of comparable risk / return.

Solvency II risk charge? What risk charge?

Similarly, the treatment of government debt under Solvency II remains very favourable compared to many other risky assets, which will be much more 'expensive' for insurers to hold when it comes into force next year.

Internal models may have a risk charge on sovereign debt, but under the standard formula, solvency capital requirements (SCR) are based on a VaR measure calibrated at 99.5%. And judging by the five quantitative impact studies it looks like sovereign bonds will be exempted from the SCR calculation. As such, it seems government bonds issued within the EEA will require no capital, regardless of rating. This is striking considering that VaRs on at least some government bonds must have risen sharply over the last couple of years.

Conversely, the longer-dated bonds and the more loss-absorbing hybrid debt that banks are being encouraged to issue under Basel III will carry higher risk-weights under Solvency II. In this regard, the objectives of Solvency II and Basel III seem to conflict.

However, that said, as Fitch points out, the move towards fair-value accounting and marking balance sheets to market does mean that cash price movements on sovereign debt holdings flow directly into their solvency position. But this is still more of an 'ex post' impact. It only really discourages an insurer from holding sovereign debt if he/she has a particular reason to be bearish on the sovereign in the short term. Arguably, against that outlook he/she would be better off waiting for a better entry point under the existing regime anyway.

Removing the regulatory hurdles

Not long ago there was strong political momentum behind the idea that bank and insurance regulation needed changing to better reflect market risk after the credit crunch of 2008-09. Banks needed to be stress tested to ensure that they could withstand adverse scenarios, thus building confidence in the system.

While that objective remains, it seems the consequences of requiring bank deleveraging in Europe in the midst of economic recession and sovereign austerity are forcing a reprioritization.

The most obvious demonstration is the decision by the EBA not to hold any stress tests in 2012. One doesn't have to be too cynical to hypothesize that all the disclosures on sovereign exposure have become a bit of a political liability at a point in time where the only buyers in size of periphery sovereign debt are periphery banks funded by the ECB.

Reports that France and Germany[6] are pushing to delay the disclosure of the Basel III leverage ratio and the date for compliance could be seen in the same vein. This was first proposed in a joint paper by Wolfgang Schäuble and Francois Baroin in January. Compared to measures that risk-weight assets, a leverage ratio quite clearly penalizes assets that have no or a low risk weight. So government bonds seem like the obvious asset class that would benefit from a delay.

To us, the tide has quite simply shifted. Objectively, there might be a strong argument for revising sovereign debt treatment in both the CRD and Solvency II, if not also in Basel III, but politically, we suspect currents are moving in the opposite direction and will continue to do so over the coming years.

As long as funding for sovereigns in markets remains jeopardy, and as long as there is no clear move towards proper fiscal solidarity in Europe, we reckon there will be a strong political incentive to make banks captive buyers. That implies a move away from marking sovereign debt to market, away from raising risk weights, away from capital ratios that don't risk weight assets and away from stress tests incorporating government bonds.

Where is the limit to financial repression?

Several banks in Spain have recently suggested that they are full on sovereign debt. In the short term, this could well dampen domestic demand.

However, we believe this is a temporary constraint, set against arbitrary risk limits. The large exposures regime (which we don't believe they have hit) excludes sovereigns that carry a 0% risk-weighting under the standardized approach. And the experience from Japan clearly shows that banks can hold much higher proportions of domestic government debt than European banks do currently.

Shareholders and bondholders may not like sovereign debt purchases. But from bank management's perspective, if you are short of capital and funding and the private sector isn't providing, then who is your ultimate master?

When subjected to the mix of carrot and stick by policymakers discussed above, then everything else equal, we believe banks will keep buying.

In Europe especially, the scale of bank purchases in the near term is very dependent on the ECB. If it prefers to use the banks as intermediaries through LTROs to the SMP or QE in its efforts contain periphery sovereign yields, then bank holdings of sovereign debt are likely to rise quickly. In the scenario where Spain and/or Italy were to apply for a more formal bail-out programme, it is entirely possible that such a programme would assume partial market access considering the size of their funding requirements. In our view, 'market access' would likely largely depend on domestic banks.

However, the ECB would be faced with an uncomfortable decision if deposit outflows accelerate to the point where banks start worrying about their liquidity again. For banks, an immediate remedy might well be to sell the very government bonds they have just bought. Extending the LTROs to cover such (uncollateralised) deposit outflows would almost invariably imply accepting more low quality collateral.

[6] Financial Times, 1 May 2012

Even beyond the particular European situation, given the regulatory incentives and the pressure on banks to raise their capital ratios and to hold more liquidity, we believe the 'true' ceiling on how many government bonds banks can hold is significantly higher than what they hold today.

How does financial repression impact bank bondholders?

Financial repression in its various shapes and guises is fundamentally altering the nature of the claim that senior unsecured bondholders have.

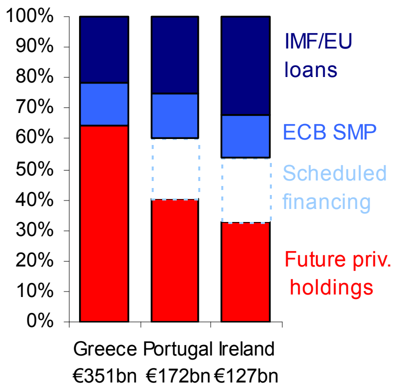
De facto, existing holders of government bonds are being subordinated by the European bailouts. As large holders, banks and other financial institutions are adversely impacted. Moreover, the bondholders in the banks themselves are ending up structurally subordinated as special resolution (or bail-in) regimes are introduced.

Investor in subordination

Following the old adage that you never default to your lender of last resort, the European rescue facilities have generally had a status akin to the IMF's "preferred creditor status" conferred on them in one form or another. As this status does not grant explicit security over assets and as it is not written into law, it isn't captured by clauses like the negative pledge that exist in some bonds.

Even lending that was done *pari passu* with unsecured creditors has ex post been elevated above private sector creditors, as we recently experienced with the ECB's arrangement with Greece, where the last-minute switch to new ISINs excluded SMP holdings from the debt swap. We regard the retroactive insertion of CACs into Greek law bonds as yet another demonstration of the fact that policymakers will, where possible, break with long-established conventions when it is politically convenient in a stressed environment.

Figure 14. Debt ownership at expiry of existing bailout programs



Source: CIRA. Assumes no future SMP purchases.

In Figure 14 we have simply taken the size of IMF and EU loans as they stand today, compared them with the total programme sizes under the existing bailouts to estimate how many bonds are in future scheduled to be refinanced using official sector loans, and estimated the ECB's current (never mind future) holdings under the SMP.[7]

It immediately becomes apparent that bondholders in Portugal and Ireland have already been subordinated more than is the case in Greece. The greater the degree of official sector intervention, the higher is the required haircut on private sector bondholders to achieve a meaningful debt reduction.

Who is most exposed to this subordination? As we illustrated above, in Italy and Spain especially, it is the domestic banks that have been adding as international investors have been scaling back exposure. In other words, investing in banks based in programme countries likely entails taking on subordinated sovereign risk.

Wrong on your rights?

Worse, regulation is pushing unsecured bondholders in banks further down the capital structure.

Bondholders were traditionally structurally subordinated to depositors in the US, but in Europe in 2007 a senior bondholder would probably have thought of himself as just another senior creditor. Senior creditors made up the vast majority of the capital structure.

[7] See p.21, *Global Economics View: Looking into the Deep Pockets of the ECB*, W. Buiter & E. Rahbari, 28 February 2012.

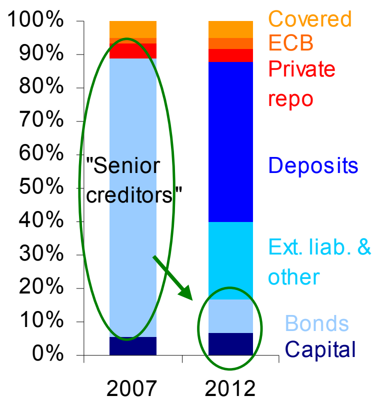
Since then, five countries in Europe[8] have introduced various forms of bail-in regimes putting bondholders in a more vulnerable position. Although Tier 2 debt generally is not supposed to be loss absorbing on a going-concern basis, we have seen holders take losses in Ireland (through a coercive exchange) and in the UK (on the argument the bank was being wound down anyway).

The *de facto* status of senior debt is more debatable. To date, only the Danish regulator has imposed losses at the senior level, and the same haircuts were applied to depositors (for deposits exceeding the deposit guarantee scheme). Reportedly, the ECB has prevented the Irish government from applying haircuts to senior bank debt holders. In Greece, moreover, it appears bank recapitalization will take place without impairing the capital structure.

However, in contrast to previous guidance the European Commission's latest discussion paper for an EU-wide special resolution regime is explicitly including senior debt in the resolution regime, and under one model long-dated bonds may end up subordinated to money market maturities and deposits not covered by guarantee schemes. A recent IMF staff position note similarly suggests many forms of senior debt may be separated out from bonds. Assuming that bonds will be treated pari passu even with guarantee schemes in a real resolution scenario is a brave assumption.

Furthermore, given the keen interest regulators are taking in subsidiaries of foreign banks, we think it likely that bondholders will find themselves subordinated also to banks' external liabilities.

Figure 15. Breakdown of aggregate Eurozone bank liabilities



Source: CIRA, ECB Monthly Bulletin

This subordination could well shut some banks out from unsecured capital markets. As funding shifts to collateralized lending from the ECB or in repo markets or securitized issuance, unsecured debt becomes more structurally subordinated still. If anything, the numbers in Figure 15 understate the problem, as banks in distress are highly likely to have pledged a greater proportion of their balance sheets in collateral than other banks.

How is this related to financial repression? Changing the de facto re-ranking of creditors ex post is a form of repression itself. But as we have seen with the LTROs, it is also likely that greater reliance on central bank funding will go hand-in-hand with more government bond purchases.

In a binary bind

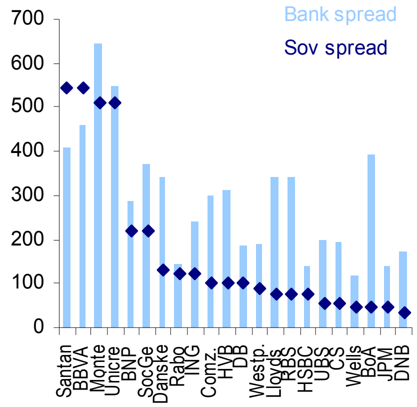
For bank bondholders in the periphery, the double subordination problem poses an awkward dilemma. On the one hand, bondholders in captive banks are more likely to be kept current, not least as over time more and more of them are likely to be domestic actors.

On the other, the unsecured bondholder is now sitting in a thin tranche, uncomfortably close to the bottom end of the capital structure. If the bank has been buying up sovereign debt at prices where there was no other demand in capital markets, then holding the bank paper has effectively become a leveraged bet on whether the sovereign is able to restore fiscal balance. It is a very binary position.

Granted, even Greek PSI did not trigger bail-ins – presumably for fear of contagion. However, we would not assume that the outcome would be the same in future PSIs or in the scenario where a sovereign leaves EMU. Both situations could leave banks with losses that extend far up the capital structure, leaving senior creditors with zero recovery.

[8] Denmark, Germany, Greece, Ireland and the UK

Figure 16. Bank vs. sovereign 5yr CDS spread, bp



Source: CIRA, Markit

If holding bank debt has indeed become a more binary proposition, then we feel it speaks for holding either securitized paper (MBS, covered bonds) or hybrid capital (where bail-in-ability is more priced in) in countries with sovereign risk. It is the risk to senior unsecured that we think is underpriced. At a minimum, we doubt that subordination effects are being properly captured in most investors' risk metrics. In low-risk sovereigns, it is less likely that losses all the way up to senior would occur and therefore the argument is less valid.

We prefer systemically important banks in low risk sovereigns

The interconnectedness of banks with sovereigns leaves us favouring systemically important banks that trade at a significant premium to their (preferably low-beta) sovereigns. We see much less upside to banks that are trading flat to their sovereigns.

For instance, we still prefer UK and US to the Spanish and Italian banks, which tend to be much tighter to the sovereign (Figure 16). Aside from the obvious implications of having an independent monetary policy, the current situation in Spain is a clear illustration of the constraints a risky sovereign faces in dealing with bank recapitalisation needs. Low risk premia provide the UK and the US with greater flexibility.

Conclusion

More to come: We believe financial repression in various forms will become increasingly common over the coming years. Central banks will probably still take the primary role in keeping real yields down, but banks and other financial institutions, especially in Europe, will almost certainly also play a pivotal part. The regulatory incentives are in place, and initiatives that discourage demand for sovereign debt from financials are increasingly getting sidelined.

We suspect that as bank demand for sovereign debt runs into natural barriers – like Spanish banks suggesting they are full on their risk limits – the temptation will be to find ways to circumvent these. If sovereigns are faced with new challenges – like capital flight for instance – we think the temptation would be to use still greater repression, such as capital controls, to counter these.

Captive bank demand can buy time and can help keeping domestic yields low. However, the distortions that build up over time can sow the seeds of an even bigger crisis, if the time bought isn't used very prudently. Specifically, having banks loaded up with domestic sovereign debt will only increase the domestic fallout if the sovereign ultimately reneges on its obligations.

On the plus side, arguably the domestication of debt ownership ought to reduce the risk of international contagion in the private sector over time. However in Europe, where the signal sent is as important as the actual losses, and where the ECB is effectively on the hook if the domestic banks fail, we are far from convinced this actually applies.

Recaps would have limited impact on credit risk premia: As banks become ever more intertwined with sovereigns, it is less and less likely that the two can sustainably decouple. This may seem obvious, but we think this is a very important point at a time where there is a lot of emphasis on bank recaps.

Granted, it would be a positive if banks could be recapped without adding an unsustainable debt burden on the sovereign. But we don't think bank capital ratios are the main driver of sovereign risk premia in Europe. They are an element, but bigger macro imbalances are the root cause. Recapping European banks might therefore help individual institutions that are trading very wide to their sovereigns, but it will make little difference to risk premia on the large number of banks already trading on top of their sovereigns. Nor would it improve their market access much. In other words, banks cannot feasibly be recapitalised to the point where the market is comfortable with the banking system unless the market is also comfortable with the sovereign in our view.

So we would regard any market-wide rally associated with even a fairly comprehensive recap of the Spanish banking sector as being temporary.

A mixed blessing for bank bondholders. It seems like a straightforward conclusion: getting banks to buy sovereign debt, at levels below where the market would price it without intervention, should be a negative for bondholders in those banks. Equally, circumventing bondholders' individual (perceived) rights and interests by subordinating them is surely negative. Both suggest the loss given default will be far higher and will extend much further up the capital structure.

At the same time, though, the bank-sovereign interdependency lowers the likelihood of default or bail-in, as long as the sovereign itself doesn’t default.

As such, investment in bank bonds, in the periphery especially, is a question of faith in policymakers – in their ability to deliver the necessary fiscal rebalancing and in their intention to honour the bargain that is implicitly being struck. No amount of trawling through bank balance sheets or non-performing loan ratios will provide the answer. It is a political decision in our view. As long as policy remains to sustain the status quo, bondholders should come out fine. Conversely, if the burden becomes too great, then the alternative will most probably involve a radical departure from current convention – to the detriment of bondholders.

We suspect this binary outcome requires a political judgement that many funds are not particularly well placed to make. Instead of those economics, accounting and finance degrees perhaps you should have done political science after all.

Notes

Notes

Appendix A-1

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