



European banks make some progress in diversifying their sovereign exposures

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In the European Economic and Monetary Union, banks' holdings of sovereign debt remain in focus, not least because of the ECB accelerating the reduction of its sovereign bond portfolio this year. Quantitative tightening at a time of significant public-sector refinancing needs requires other investors to pick up the baton. Will banks resume their traditional role as anchor investors? Or will they remain reluctant to increase their holdings, as they were in 2023? Moreover, differences in the sovereign exposures across national banking sectors – especially with regard to “home bias” – have been an obstacle to completing the Banking Union with a European Deposit Insurance Scheme (EDIS), and thus continue to receive attention from policymakers. The good news, as we show in this report, is that European banks in aggregate made some progress in 2023 toward diversifying their claims on governments.

Banks' sovereign exposure and ECB quantitative tightening

Last year, EMU governments issued a substantial net EUR 537 bn in new bonds. Banks played only a minor role as investors, while rising yields and low volatility brought especially foreign investors and private households back to the market.¹ Meanwhile, the ECB loosened its tight grip on the sovereign bond market. It did not reinvest proceeds from maturing securities of roughly EUR 200 bn, leaving its holdings at EUR 4 trillion at the end of 2023 (ca. 38% of the market at face value).

For this year, the ECB has committed to reducing its holdings by over EUR 300 bn, while public-sector funding needs will hardly ease. If the market turned out to be reluctant to absorb more euro-area government paper, banks might step in as they have done before (see Chart 1). Possibly, the focus could shift back to domestic sovereign debt.

Taking stock of sovereign exposure in the euro area

Sovereign exposure consists of three regional dimensions – domestic, other euro-area, and non-EMU –, and two main types of instruments – public-sector loans and bonds. In 2023, euro-area banks' aggregate exposure vis-à-vis their domestic governments remained almost unchanged at EUR 2 trillion (EUR -13 bn, -0.6% yoy). This is a substantial share of their balance sheet total, equalling 5.4% of their total assets. Compared to the size of the euro-area economy, it

¹ Anaya Longaric, Pablo, et al. (2023). Sovereign bond markets and financial stability: examining the risk to absorption capacity. In: ECB, Financial Stability Review. November.

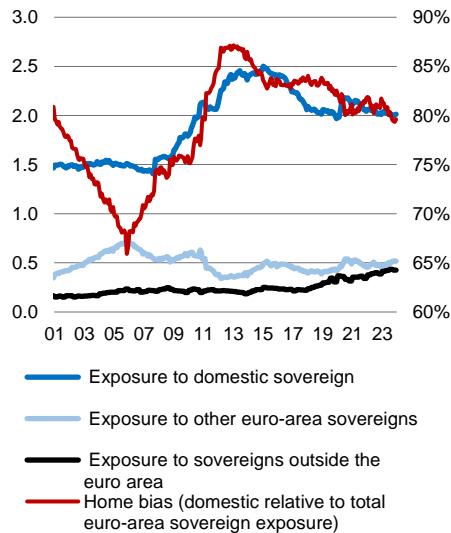


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2008, 2011, 2020: Banks finance their home governments in times of crisis

1

Euro-area banks' exposure in EUR tr (left), home bias in % (right), until December 2023



Sources: ECB, Deutsche Bank Research

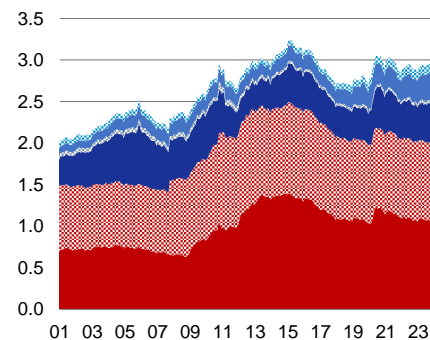
even amounts to 14% of GDP. At the same time, banks increased their claims on other euro-area governments substantially, by EUR 65 bn or 14% to a total outstanding of EUR 516 bn. As regards the split between the two instruments, banks expanded their bond holdings while slightly reducing the loan book. The latter now accounts for a still sizeable 39% of the EMU sovereign exposure as a whole. Beyond that, banks also increased their holdings of public-sector bonds issued outside the euro area, such as US treasuries or UK gilts. But total claims on non-EMU sovereigns continue to be only a fraction of the EMU exposure – they stood at EUR 425 bn in December (+10% yoy). Gross sovereign exposure overall grew to EUR 3 trillion (+4% yoy and equivalent to a heavy 21% of GDP) (see Chart 2).

For years, the composition of the EMU sovereign portfolio has particularly been in the focus of policymakers and investors. Bank exposure remains significantly tilted towards the home country, despite no differences in the regulatory treatment across the EMU. Domestic sovereign debt² still makes up 80% of total euro-area exposure. However, this is 2 pp less than a year ago. Even more, the “home bias” has come down to the lowest level since the European debt crisis. In relative terms, as a percentage of total assets, domestic sovereign debt remained unchanged. A measure of risk, exposure size relative to capital came down to 73%, still a high share but the lowest ratio on record (see Chart 3).

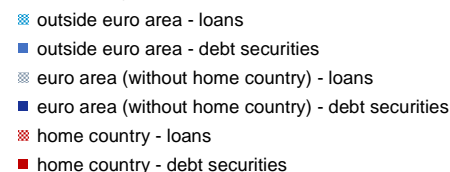
2023: Stable claims on domestic sovereign - rising investment abroad

2

Exposure of euro-area banks to general government in EUR tr, until December 2023



Exposure to governments located (in) ...

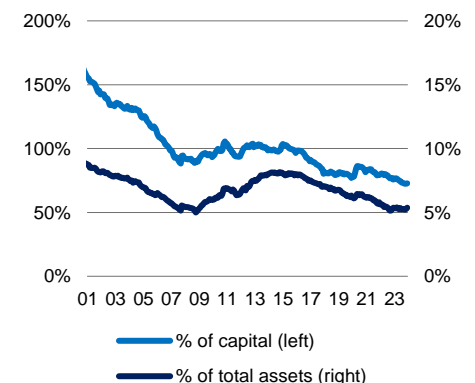


Sources: ECB, Deutsche Bank Research

Lower exposure relative to capital in 2023

3

Euro-area banks' exposure to respective domestic government, until December 2023



Sources: ECB, Deutsche Bank Research

Spotlight on national banking markets

Aggregated euro-area banking sector figures mask significant national differences, though, within the monetary union. Of particular importance are the five largest individual banking markets, which together account for 84% of total EMU bank assets: France, Germany, Italy, Spain, and the Netherlands.

² “Debt” refers to both bonds and loans.



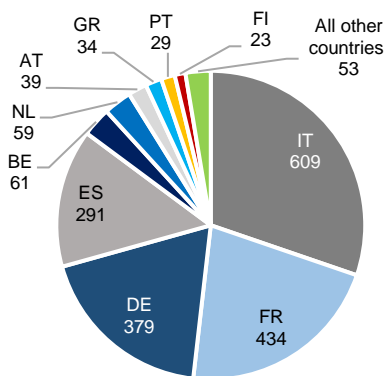
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In absolute terms, Italian banks have invested the most in domestic sovereign debt, followed by France and Germany (see Chart 4). Relative to total assets, Italian and Spanish banks are in the lead, while Dutch banks are the most restrained (see Chart 5). In all five countries, the ratios did not change much in 2023. Sovereign claims in relation to capital declined considerably for Italian and Spanish banks, based on both a reduction in exposure and an increase in capital (see Chart 6).

EMU bank exposures to domestic sovereigns

4

EUR bn, December 2023

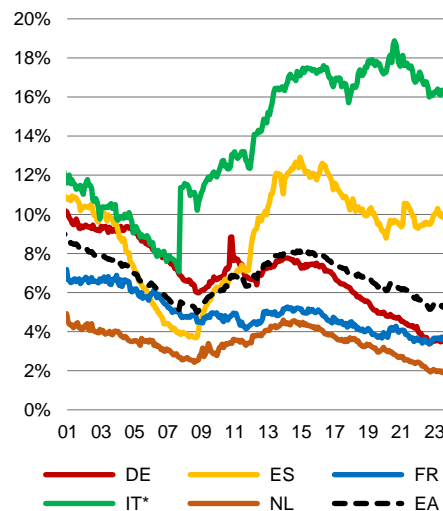


Sources: ECB, Deutsche Bank Research

Italian and Spanish banks remain the most exposed

5

Domestic sovereign exposure in % of total assets, until December 2023



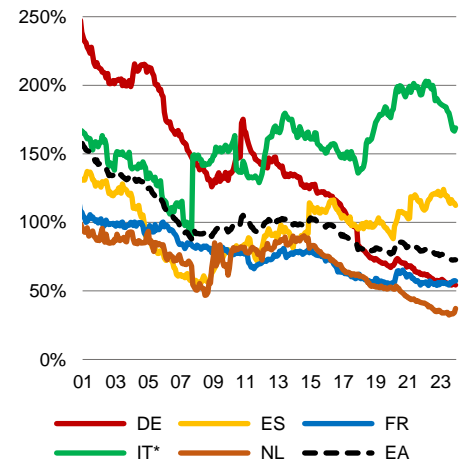
* Surge in 2007 due to a statistical reclassification of loans.

Sources: ECB, Deutsche Bank Research

But declining claims relative to capital in Italy and Spain

6

Domestic sovereign exposure in % of capital, until December 2023



* Surge in 2007 due to a statistical reclassification of loans.

Sources: ECB, Deutsche Bank Research

Among the large markets, the home bias is now the highest in France, where it oscillates around 90%. Italian banks, by contrast, have been slowly reducing the relative weight of domestic debt since the end of the European debt crisis. But it remains high at 86%. Dutch banks are the most diversified – probably also because of a more limited supply of domestic bonds. Surely no coincidence, the countries with the lowest sovereign yields – the Netherlands and Germany – have the lowest home bias (see Charts 7, 8).

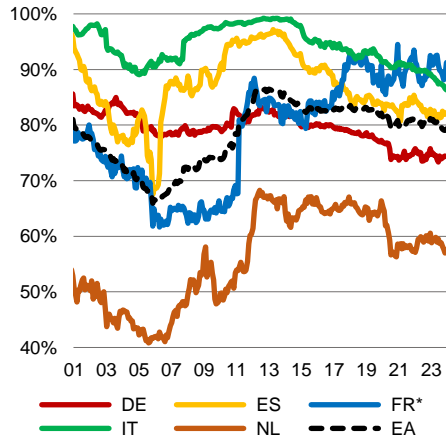
What also differs is how banks hold government debt. In Italy and Spain, this mostly happens through bonds. In Italy, they account for 59% of banks' claims on the domestic sovereign, and for 73% in Spain. In Germany and the Netherlands, it is the other way round – i.e. loans prevail (share of 67% and 82%, respectively). French banks used to belong to the second bracket. But over the past five years, they have increased their bond investments, raising the share to 51%, while keeping loans flat (see Chart 9).



European banks make some progress in diversifying their sovereign exposures

7 Home bias: Falling in most countries but still strong

Domestic relative to total euro-area sovereign exposure, until December 2023

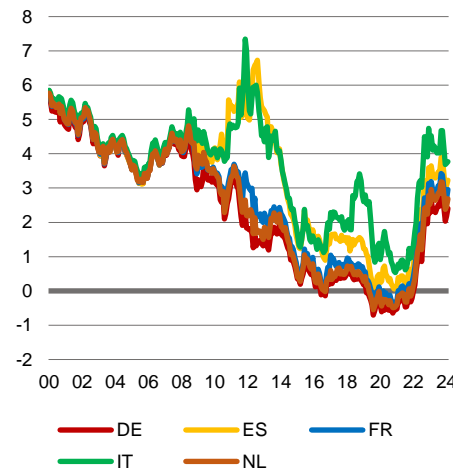


* Surge in 2011 due to a statistical reclassification of other euro-area bonds.

Sources: ECB, Deutsche Bank Research

8 Italian and Spanish bonds offer highest yield

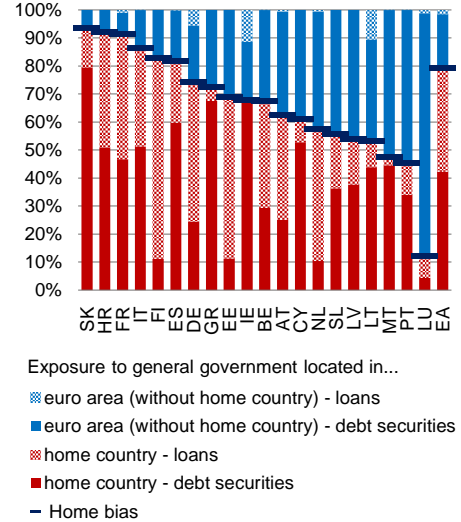
10-year government bond yield in %, until February 2024



Sources: WEFA, Deutsche Bank Research

9 Pronounced home bias in most countries

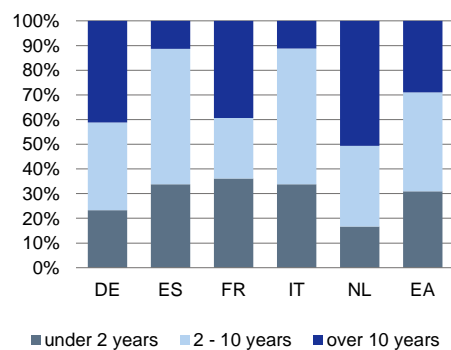
% of total bank exposure to EMU governments, December 2023



Sources: ECB, Deutsche Bank Research

10 Longest remaining maturities in NL, DE and FR

Domestic sovereign exposure by remaining maturity, June 2023



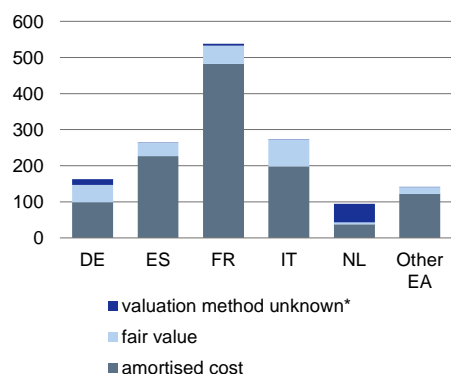
Sources: EBA, Deutsche Bank Research

With respect to remaining maturities, the same country groups emerge again. Banks in Italy and Spain clearly prefer shorter maturities; only 11% of their holdings are long-term. By contrast, maturities over 10 years account for 41% and 51% in the portfolios of German and Dutch banks, respectively. This figure is similar for French banks (39%), yet their share of maturities below 2 years is higher than in Germany or the Netherlands (see Chart 10).³

From a risk perspective, the type of debt instrument and the valuation method matter as well (see Chart 11). Loans are usually held at amortised cost, while bonds can be held at either amortised cost or fair value. In 2023, higher interest rates triggered lower valuations of securities held at fair value. But even bond portfolios held at amortised cost received heightened attention because they are regarded as liquidity buffers. If book value and market pricing differ significantly, investors and depositors can lose confidence, as witnessed during the US regional bank crisis in March last year. In the euro area, banks hold sovereign debt mostly at amortised cost, not least reflecting the considerable share of loans.

11 Interest rate risk limited by high share of holdings at amortised cost

Domestic sovereign exposure, EUR bn, June 2023



* In NL, relates entirely to Nederlandse Waterschapsbank which extends loans to the public sector.

Sources: EBA, Deutsche Bank Research

³ Based on European Banking Authority (EBA), Transparency Exercise 2023. Please note that EBA data comprise about 80% of the euro-area banking sector by total assets. However, coverage differs substantially between countries – it is only about 50% in Germany, for instance.



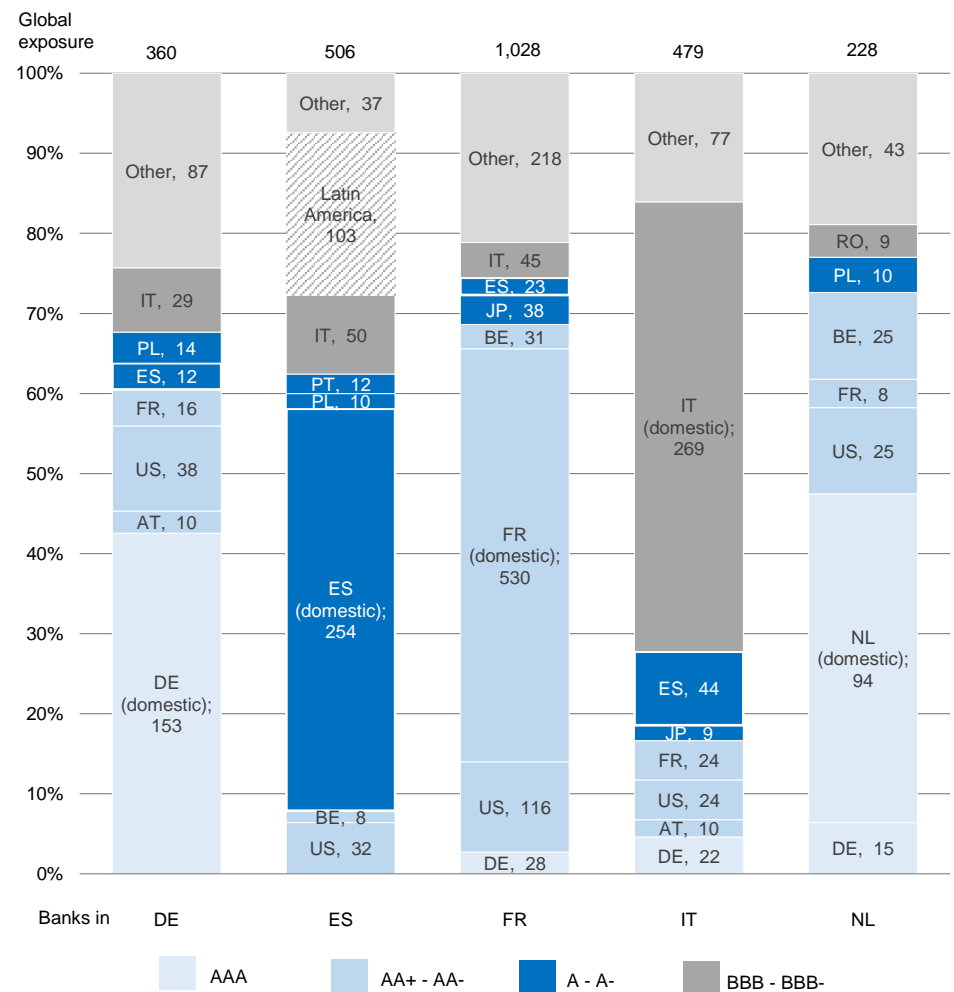
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Sovereign risk on bank balance sheets – the elephant in the room

Differences in sovereign ratings remain the stumbling block when it comes to finishing the Banking Union. The credit risk of a national banking sector is strongly impacted by the rating of the home sovereign – primarily because of banks’ typically strong dependence on the domestic macroeconomic performance, but also due to their substantial direct public-sector exposure (see Chart 12). Cross-border diversification remains low for banks despite the same prudential treatment for all euro-area sovereign debt. Under current rules, there are no capital charges or concentration limits to mitigate sovereign risk on bank balance sheets, although such claims are in scope of the leverage ratio requirement.⁴ The strong home bias may have several reasons – loans are one of them. They are mostly taken out by lower levels of government which might explain why there are few cross-border loans. Also, there could be closer business ties between domestic banks and authorities. In addition, diversification has been particularly unattractive for banks in countries with higher sovereign yields, especially in the negative-rate environment.

Different risk content of banks' sovereign portfolios by country

Sovereign exposures by issuer and credit risk rating in EUR bn, June 2023



Sources: EBA, Fitch Ratings, Deutsche Bank Research

⁴ For a detailed discussion of banks’ sovereign exposures and the sovereign-bank nexus in the euro area, see Mai, Heike (2021). What to do with home sovereign exposures? Reducing risks to make the Banking Union stronger. Deutsche Bank Research. EU Monitor. March 22.



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Because of the large home bias, the sovereign-bank nexus remains strong. In times of crisis, banks have proven to be reliable buyers of paper issued by their home government. This can potentially lead to a mutual destabilisation of public finances and the banking sector. In the European debt crisis, financial support from other EMU members was needed to overcome such vicious circles. The lessons drawn were the blueprint for the Banking Union: reduce risks on bank balance sheets and harmonise bank supervision and crisis management. The Single Rulebook, the Single Supervisory Mechanism and the Single Resolution Mechanism have been implemented. The European Deposit Insurance Scheme (EDIS), though, which would provide the same degree of protection to all depositors throughout the EMU, continues to be stuck in political deadlock. While some member states call for a speedy and full mutualisation of deposit insurance, others insist on risk reduction before risk sharing. Non-performing loan levels have converged over the years, but sovereign risk remains the elephant in the room.

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