

Opinion **Free Lunch**

## The landing zone for Europe's banking union

To get out of deadlock, euro members should compromise over 'safe portfolio' solution

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It is not something that tends to hit the front pages, but one of the most promising developments in European policymaking is the attempt to make the monetary union, and in particular its banking system, work better. Even if mostly noticed for deadlocked disagreements (when it's noticed at all), the process of completing the "banking union" that was started in 2012 has a [better chance of succeeding](#) than many think. The next few months are crucial, with opportunities to agree compromises — or fail to do so — at European summits in March and June.

The main objectives are shared and well understood: to end the "doom loop" between banks and national governments, which was how the eurozone financial crisis got as bad as it did. The doom loop is the interdependence of national governments and national banking systems that, on the one hand, makes banks vulnerable when "their" government is in financial trouble (because they are heavily invested in its public debt), and, on the other, that puts a government in financial peril when "its" banks face bigger losses than they have capital to absorb (because of the political pressure to cover those losses with taxpayers' money).

The doom loop still has not been disabled. On the bank-to-sovereign side, we have seen several bank failures that have ended up with taxpayer money being injected, despite European laws and agencies ostensibly designed to prevent this. On the sovereign-to-bank side, a number of eurozone banks still have holdings of their home country's sovereign bonds that are uncomfortably large relative to their capital cushions.

Efforts to disable the doom loop have stumbled on one issue in particular: how do you reduce banks' exposure to high-debt governments without making it harder for those governments to fund themselves, thereby risking their financial stability? For example, how do you make Italian banks safe from the Italian government without putting Rome in danger of not being able to borrow? As I described in a [column](#) this week, if an answer could be found to this, it looks like those governments most worried about their vulnerability in financial markets — Italy above all — could accept regulatory limits on banks' sovereign exposure.

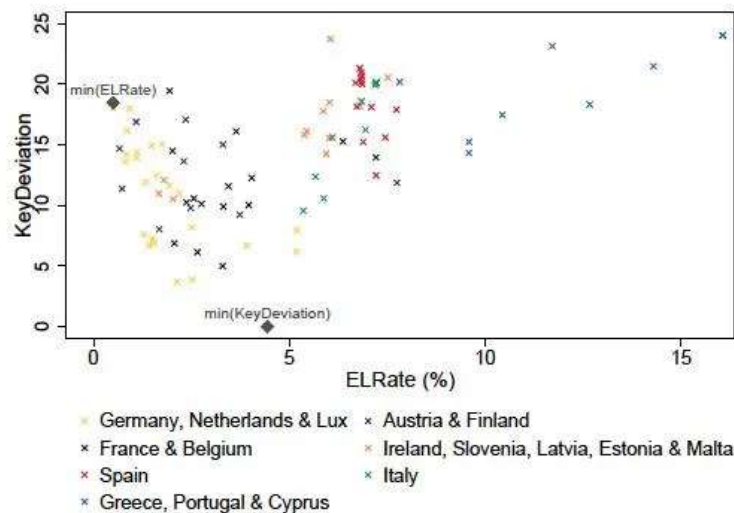
The traditional answer has been joint borrowing by all eurozone members together — a common “safe asset” where everyone is liable for the borrowing of all. The much more promising answer now emerging is this: if (say) Italian banks held fewer Italian bonds, could you get other countries' banks to hold more?

This solution was hinted at in the German finance ministry's [proposal for banking union](#) in November last year. And now the Spanish MEP and economics professor Luis Garicano has presented [specific proposals](#) for how to fashion the rules to disable the sovereign-to-bank side of the doom loop in this way. (Garicano also wants to disable the bank-to-sovereign side, by strengthening the powers and funding of the euro-level apparatus for resolving failing banks.)

The idea is to encourage all eurozone banks to hold more bonds of *all* governments even as you discourage each country's banks from holding too many bonds of *their own* government. Instead of a “safe asset” which mutualises government obligations, regulations would be adapted to reward banks for holding a “safe portfolio” of (non-mutualised) public debt. In this way, banks would no longer be vulnerable to their own governments' financial trouble, but all governments would still have a market for their bonds.

In Garicano's model, banks would be required to post capital against government bonds they hold, but only insofar as their holdings differed from a specified weighted portfolio of all eurozone bonds, defined by the countries' capital share in the European Central Bank (which follows the size of the economy). The more unbalanced their holdings, the more capital banks would need to post. The fact that the favoured portfolio would be what the central bank buys should encourage them further to hold it.

A safe portfolio is not the be-all and end-all solution, economically speaking. Banks that reallocate their portfolios away from exposure to a single sovereign may end up swapping concentration risk for credit risk. That is because when a bank diversifies to reduce its exposure to one sovereign, it may take on bonds that on their own are riskier than the one it held before reallocating its portfolio. Spyros Alogoskoufis and Sam Langfield, researchers at the ECB, have explained in detail why new capital rules that encourage a shift to more diversified portfolio of sovereign bonds [may not be able to avoid a trade-off](#) between concentration risk (and the doom loop) and plain old credit risk (see chart below).



For this reason, Garicano argues that the safe portfolio approach is just the first step, which must be followed by favouring the safest tranche of an engineered security backed by the safe portfolio but with risks sliced off to tranches. The end point — which he thinks should be committed to from the start — would be securitised “European Safe Bonds” or “ESBies”, which we have [discussed before](#).

But there is a difference between what works politically and what works economically. ESBies are a good idea, but have met a lot of resistance, not always justified. But insisting that they must be the end of the process risks letting the best become the enemy of the good. The basic safe portfolio approach is the most promising compromise zone and would no doubt encourage private securitisation activity in any case (for example, banks that increase risk when diversifying their sovereign bond holdings could package them and sell-off the riskier junior tranches on their own initiative). Banking union depends on settling for the most sensible, if not ideal, economic solution that can secure a political compromise.

## Other readables

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