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2 December 2019

ILLIQUID SECURITIES: THOSE RISKS THAT GERMANY DOESN'T WANT TO SEE

by Marcello Minenna

The debate on the European deposits insurance scheme – planned for years as the third pillar of the Banking Union alongside the single supervision and the single resolution mechanism – has rekindled recently in the wake of a position paper released in early November by the German Minister of Finance, Olaf Scholz. The paper provides for a supranational reinsurance system, called to intervene to guarantee protected deposits (up to €100,000) only after national deposit guarantee schemes (DGS). Therefore, in protecting its depositors, each country should use first of all the sums set aside by its DGS through the (ordinary and extraordinary) self-contribution of domestic banks and the European guarantee fund should get involved only in case of depletion of the sums available at the national DGS.

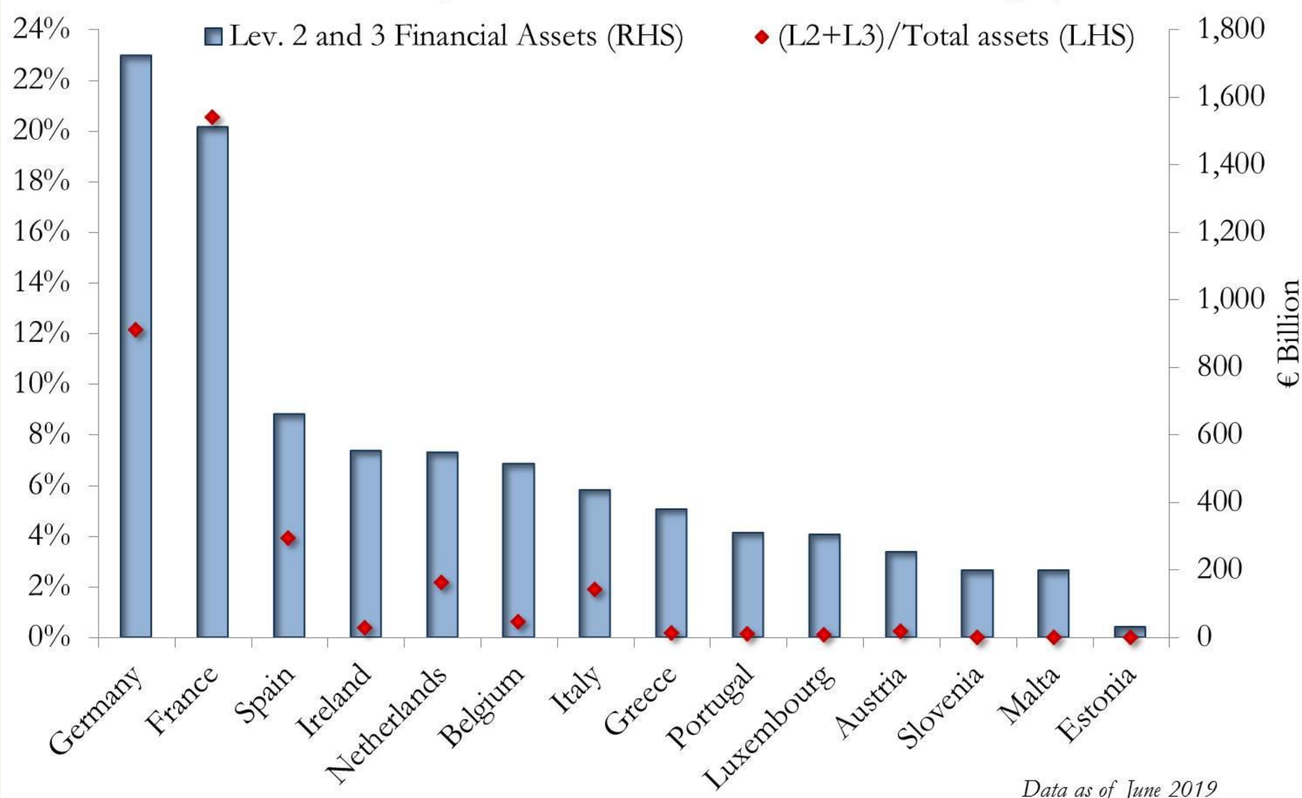
Covered deposits are around 33% of the total sums deposited with the Eurozone banks (€18 thousand billion); but, obviously, national protection funds have limited financial resources to be used in case of need.

Common sense considerations on the dynamics of contagion among credit institutions, on bank runs in moments of panic and on the related contingent liquidity/solvency problems lead to doubt that a country can really rely only on the resources of its national funds (and their requests for extraordinary contributions) when an adverse scenario for depositors materializes. In case of need, the lender of last resort becomes the individual member State and therefore its taxpayers. This explains why deposits' safety is essential to safeguard the financial stability of the various countries and of the entire euro area, making a supra-national insurance appropriate (if not indispensable).

Nevertheless, Scholz's proposal subordinates the third pillar of the banking union to multiple conditions: the introduction of risk weights on banks' exposures in government bonds exceeding pre-established concentration limits, a 5% ceiling on the amount of gross non-performing loans, a unique European law on bank insolvencies and a new European legal format for credit institutions. As usual, the argument used is the need for risk reduction and for a fairer competition between member countries' banking systems.

Several experts have already highlighted the criticalities of these conditions. In my opinion, however, it is appropriate to dwell also on a risk factor completely overlooked by Scholz and which is instead very relevant for banks in the core countries. I refer to illiquid securities accounted for at fair value in banks' balance sheets. These assets – also known as Level 2 and 3 securities – often present a complex financial engineering that makes it difficult an accurate pricing starting from market data. The opacity of the structure exposes them to the so-called valuation risk, *i.e.* the risk of recording in the balance sheet at a value more or less far from the correct one.

Currently, the Franco-German banks jointly hold 72% of the approximately €3,400 billion of Level 2 and 3 securities present in the Eurozone banks' balance sheets. In particular, the incidence of Level 2 securities is very high: a seemingly reassuring figure since, theoretically, their price derives from observable market data while that of Level 3 does not; but many practitioners report regulatory arbitrages between the two classes of securities aimed at benefiting from the most favorable regulatory treatment reserved for Level 2.

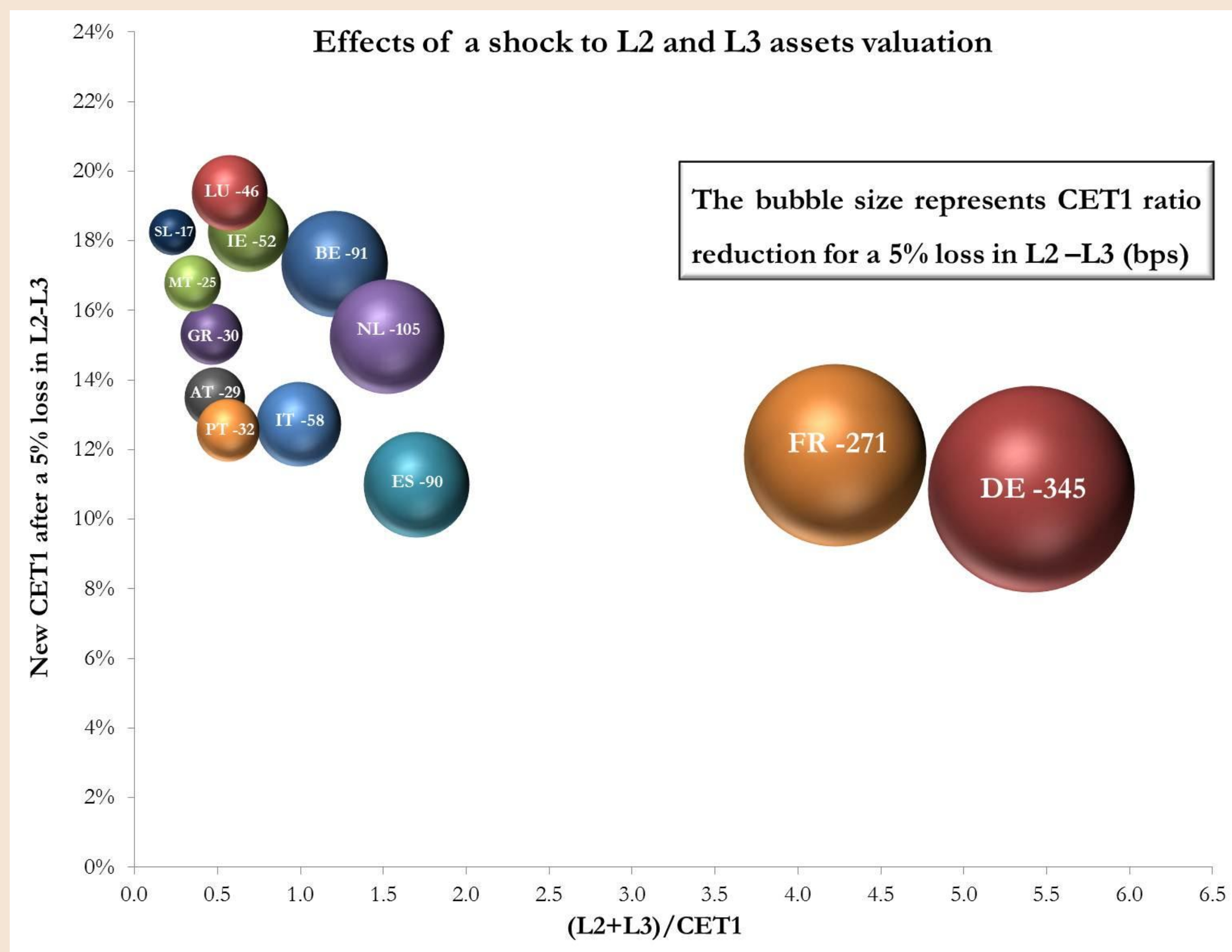


In absolute terms, illiquid securities held by German banks (€910 billion) are less than those held by French players (€1,540 billion); however, in relation to the overall size of the assets of the two banking systems, German credit institutions are the most exposed with an average incidence of 23% (and peaks of over 40% for single names), against 20% of French ones.

Much less is instead the exposure to illiquid securities by peripheral banks. Italy, in particular, is under €150 billion, less than 6% of its banks' total assets. This difference from central and northern Europe is linked, *inter alia*, to the different banking attitudes: French-German institutions are relatively more oriented towards investment banking (including, therefore, securities trading) compared to competitors from southern Europe that instead are comparatively more oriented to commercial banking (and therefore also to loans to the real economy, which also helps to explain the greater incidence of impaired loans).

So far, European banking supervision has been rather lenient towards these exposures. Yet it is known that the wrong assessment of such financial products was the main trigger of the global financial crisis.

In a 2017 paper, the Bank of Italy simulated the reduction of CET1 (1st level supervisory capital) on a sample of European banks in the scenario of a 5% loss on the respective portfolio of Level 2 and 3 securities. Repeating the exercise on the data of the main national banking systems of the Eurozone updated to June 2019, it comes out that German banks would be those most affected with a decrease of 345 basis points in their CET1, followed by French ones (-271) and Dutch (-105). Even Spanish and Belgian banks would suffer some impact (around 90 basis points), while the CET1 of Italian institutions would drop by 58 basis points.



The proposal of the German Minister of Finance – promptly endorsed by his French counterpart (Le Maire) – represents a selective application of the concept of risk reduction, concentrated exclusively on reducing the risks of others but not of their own.

Not to mention that Scholz's paper comes at a very delicate time for German banks that, in a context of high sectoral fragmentation (and despite the substantial aids received from

the public sector before the tightening of EU rules, but also after it — as shown by the recent rescue of NordLB) struggle to reach barely satisfactory levels of profitability. Circumstances that help to understand why Germany is now opening to the European deposit insurance.

The issue of the high incidence of opaque and illiquid securities must be brought to the attention of European partners in the ongoing debate on risk reduction, the preservation of financial stability and the supranational deposit guarantee scheme. Otherwise – as happened in Deauville, Meseberg and Aachen and how it could also be for the reform of the European Stability Mechanism – we would continue to allow the Franco-German axis to define the rules outside the European institutions and to exalt our vices and their virtues. And meanwhile risk sharing in the Eurozone would continue to be postponed indefinitely.

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