

Does the euro area need a safe or a diversified asset?

Daniel Gros

Key points for policy-makers

The banking system of the euro area can be stabilised even without creating a new ‘safe’ asset. The real problem is the concentration of risk on bank’s balance sheets in the form of large holdings of bonds of the home sovereign. Diversification should be the first priority. But the current regulatory framework hinders diversification of sovereign risk because existing investment funds of euro area government bonds are treated as if they were much less safe and liquid than the individual government bonds themselves.

On May 24th, the Commission proposed ‘enabling’ legislation for the creation of sovereign bond-backed securities (SBBS). Enabling SBBS is useful, but they require a new framework for the tranching involved, with no track record in markets. It is thus highly uncertain whether SBBS will be widely adopted. By contrast, the approach proposed in this contribution would rely on an existing globally recognised framework (e.g. the Luxembourg or Irish UCITS or electronic-traded funds – ETF), widely used by market participants today.

Policy recommendations

Regulators should treat regulated funds based that invest only in euro area government securities in the same way they treat the underlying government bonds (the ‘look-through approach’). This applies in particular to two key issues: capital and liquidity requirements. As long as government bonds have a zero-risk weight (under the standard Basel approach), euro area banks should not have to hold any additional capital on funds based only on euro area government securities.

The same treatment should apply to the liquidity cover ratio (LCR), which obliges banks to hold a buffer of cash or liquid high-quality securities. Investment funds (of ETF) of euro area government bonds should be put into the same liquidity category as government bonds themselves. Diversified funds of the debt of many countries have a more stable market value than even the safest individual country bond. They should thus become the preferred instrument to satisfy liquidity needs.

Funds that contain euro area government bonds in proportion to the capital key in the ECB should be recognised as ‘diversified’ and therefore exempted from the large exposure limits.

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Introduction

It is often argued that the euro area lacks one key element, namely a ‘safe’ asset. In countries with their own currency, government bonds are usually considered ‘safe’ because it is assumed that in an emergency the government can always force the central bank to print enough money to service its debt. But this is not possible in the euro area, given that no single government can force the ECB to underwrite its debt. The Maastricht Treaty, in fact, expressly forbids any so-called monetary financing. Bonds jointly guaranteed by all member states might also be considered ‘safe’, but they would not be compatible with the Treaty and would require a degree of mutual support that does not exist at the present time. This was also recognised in the Commission’s proposal for sovereign bond-backed securities (SBBS) of 24 May 2018.

The importance of a safe asset in general is actually not universally recognised (Portes (2013)). The argument made in the context of the euro area is more practical, namely that sovereign risk presently held on banks’ balance sheet is very concentrated. Banks in some large countries (mainly Italy, Germany and Spain) hold mostly domestic government bonds in their portfolios. Large holdings of the debt of the home sovereign contribute decisively to the so-called diabolical loop, as any weakness of the sovereign bond market will immediately weaken the banks of that country. Bank holdings of domestic sovereign bonds are at times twice the size (or more) of their total equity. Under these conditions, any loss, even a partial loss, of the value of the home country’s sovereign bonds will have a strong impact on the solvency of the country’s banks.

How can this dilemma be solved? Some have argued that banks need a ‘safe’ asset to be able to hold fewer bonds of their own government because banks need safe assets on their balance sheets. This is the line taken by the High-Level Task Force on Safe Assets of the European Systemic Risk Board (ESRB, 2018). In its proposal, the safe asset could be created by bundling and tranching existing government bonds as spelled out in more detail in the Commission proposal mentioned above: a special purpose would buy government debt (pro rata the ECB key) and would then designate 30% of the proceeds as a junior tranche. In the event any single (or number) government defaults, this junior tranche would carry the loss. Since it is highly unlikely that at any point in time, countries representing more than 30% of the euro area would default together, the senior tranche (i.e. the 70%) would represent a ‘safe’ asset.

This contribution proposes a much simpler and less ambitious approach, namely to concentrate on diversification rather than safety. In principle, diversification can be achieved already today by banks buying the bonds of many sovereigns. But this entails costs as it would multiply the positions to be taken, sometimes in illiquid markets, and it would require the bank to conduct due diligence on many different sovereigns. Given these drawbacks (and the sometimes not-so-subtle pressure of national authorities), many banks simply hold only the bonds of their home sovereign.

Many thus argue that banks need to be forced to diversify their holdings of government bonds (see ASC, 2015, for a survey of the arguments).

Diversification of sovereign risk could in principle be enforced simply by applying the ‘large exposure’ Directive¹ also to sovereigns, which simply states that no single exposure should be higher than 25% of a bank’s capital. This limit is independent of the quality of the exposure and thus also applies to AAA-rated credit. It does not apply to sovereign risk, however, which is thought to be riskless under the standard Basle approach. Of course, most large banks avail themselves of their own risk models, which they then must apply throughout their entire balance sheet, but thanks to the ‘permanent partial exemption’, they are allowed to use the standard approach for sovereign exposure (for details, see Gros, 2013).

It is often argued, however, that applying the large exposure Directive to sovereign holdings would lead to a net reduction in the demand for certain (e.g. Italian) bonds, as banks from Germany would simply substitute their holdings of Bunds by buying French, Dutch and other safe bonds. This fear is probably exaggerated as shown by de Groen (2015).

This note thus proposes a new measure, which could mitigate this problem by creating a new class of diversified assets.

A first simple step: Fostering diversification by recognising reality

A simple first step which could be taken immediately would be to recognise that bank holdings of investment funds should not be regarded as more risky and less liquid than holdings of the underlying securities. One would end the existing, *de facto* discrimination against diversification (on bank balance sheets). If a bank holds government debt via investment funds, which bundle euro area government debt, it has to hold more capital and these holdings are not considered liquid. Such funds already exist in large numbers with different characteristics in terms of maturity and degree of coverage of the euro area. They rely on a globally recognised legal framework with wide market acceptance. However, banks do not hold these funds because even a fund whose underlying securities consists only of euro securities would be subject to a capital charge and would not be regarded as liquid. This does not make sense and should be changed.

The fact that these funds are already available on a large scale is important because each bank has different needs in terms of maturity and the coverage it prefers. Moreover, these funds (e.g. Luxembourg or Irish UCITS, or ETF) can have very low transaction costs and do not need to be constantly rolled over. By contrast, the SBBS proposed by the Commission would be based on an initial investment that cannot be changed, which means that the maturity changes over time, making different issues of SBBS less fungible.

¹ For details on the large exposure limit, see <https://www.eba.europa.eu/regulation-and-policy/large-exposures>.

De-risking through diversification: The EMU basket

A second step could then be taken which would be based on the following approach: In addition to extending the large exposure limit (after a long transition²) to sovereign holdings, the authorities³ could recognise a certain class of investment funds or exchange-traded funds (ETFs) as “diversified” and thus exempt them from the large exposure Directive. These funds would contain only a representative basket of sovereign bonds of euro area governments. The weights in the basket could be equal to ECB capital shares (which are the simple average of GDP and population weights). This type of asset would thus reflect the (weighted) average of the euro area. A first advantage of this basket would be that any flight to safety from one country to another would not affect the value of this asset.

Moreover, this basket average should also be ‘safe’ in the sense that it would have a stable value, of course, while not necessarily being immune to a small loss if a single sovereign would default (for example, the Greek default with a haircut of about 50% would have led to a loss of value of the basket of less than 1.5%).

A straightforward consequence of the ‘no bail-out’ clause in the Maastricht Treaty is that any single sovereign must be regarded as potentially risky. But it is also clear that in the extremely unlikely event of a run on all government bonds, the ECB would intervene to stabilise the market. By contrast, the ECB will not necessarily intervene to maintain the value of any single sovereign. The average of all sovereign bonds could thus have a somewhat higher probability of a small loss (than any of its single components); but the probability of a large loss should be much smaller.

Stability versus safety

The stabilising properties of the EMU basket can be seen in the actual data. Figure 1 below shows the volatility (measured by a one-year rolling standard deviation of daily returns) of three assets, two of which constitute the main components of the euro area’s debt market: German and Italian bonds. The third is the EMU basket described above: an average of the returns on euro area sovereign bonds, using ECB weights.

The figure shows that the variability of the Italian bonds (in this case, with about a 7-year duration) is in general higher than that of a Bund (with similar duration). However, the EMU basket is always more stable than the Bund. The difference in volatility between the Bund and the EMU basket is naturally highest during the crisis in the euro area (2011-13), as during this time the correlation between Italian and German yields was negative due to investors’ flight to the safety of the Bund. The data thus confirm the general principle that the safest asset is not

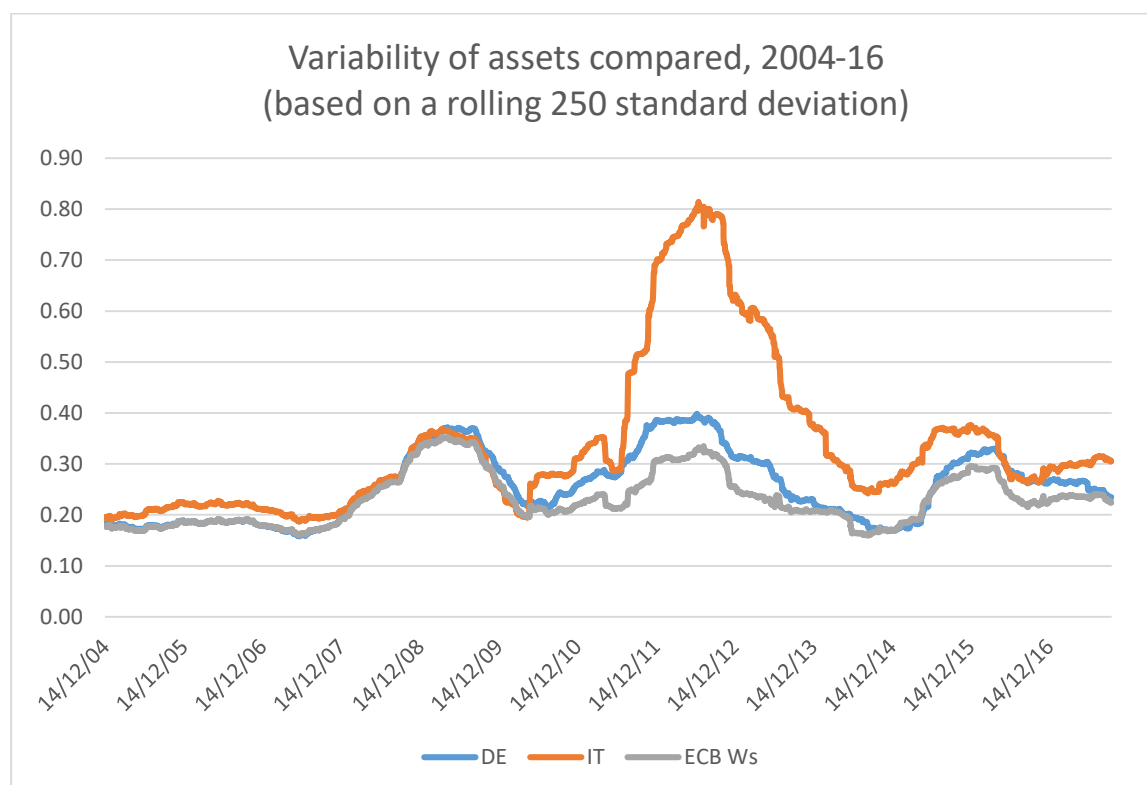
² For example, the limit on the exposure on any one sovereign might initially be set at 275 % of equity, which could be reduced in ten equal steps of 25 points to 25% of equity by 2028.

³ This could mean the European Banking Authority (EBA) or the European Securities Markets Authority (ESMA).

necessarily the one with the most stable value. The Bund might be rated triple A, but its value is less stable in general than that of a basket of all EMU currencies.

This result, that the Bund might be less stable in value than a basket of EMU currencies, which would probably receive a lower rating, is less paradoxical than might appear at first sight. In practical market terms, it is easy to understand. When there is a sudden shift towards Bunds, perhaps because of a sudden reduction in the risk appetite of investors (= flight to safety), the price of the Bunds can rise above par since German long-term interest rates will fall. Any reversal in risk appetite, however, would lead to a reversal of the original increase in German interest rates, and thus a fall in the price of Bunds. The price of Bunds could thus fluctuate quite widely. During the euro crisis, the price of 10-year Bunds at times went above 140% of their nominal value, but then fell again. Nevertheless, Bunds are still considered AAA, because the ratings agencies (and everybody else) considers the likelihood of a default of the (federal) German government on its own debt as extremely unlikely. The rating thus refers only to the likelihood that the debtor will pay interest and principal (at par and on time), not the short-term stability of the market value of the asset in question. To the extent that banks hold sovereign bonds for their liquidity, it is the latter, i.e. the short-term stability of the market value, that should be more important than the long-term safety in nominal, par terms.

Figure 1. The stabilising properties of an EMU basket



Note: DE refers to the JPMorgan EMU German government bond index, IT to the Italian index and ECB Ws to the average (weighted with ECB shares) of euro area government bond indices from the JPMorgan EMU index.

Source: Own computations.

The summary statistics of these assets are described in Table 1 below. This table also contains the summary statistics of the main commercially available basket, namely the JP Morgan EMU index. This index uses as weights the market value of the outstanding tradable debt of each country. Its weights are thus somewhat different from those of the ECB.⁴

This table shows that over the 13-year period considered here (2004 to 2017), the EMU basket would have dominated the Bund, as it had a considerably higher total return and a lower average volatility throughout the period

An EMU basket would thus have provided banks with a more stable asset and a higher average return. Banks could have held very large amounts of this asset since it would be exempted from the large exposure limit. If Greek banks had held this basket instead of bonds of their own government, their re-capitalisation needs would have been more than €40 billion lower; and the government would have less debt today to the tune of over 20% of GDP. For Italy, the crisis in 2011-13 might have been also much less severe, because the feedback loop would have been mitigated.

Table 1. Statistical properties of major bond markets

Data as of Sep 28th, 2017	Performance since 31/12/2004	Volatility	TEV vs ECB Weighted	Correlation vs ECB Weighted	Mod. Dur.
JPMorgan EMU Germany	66,10%	4,21%	3,10%		7,30
JPMorgan EMU Italy	82,10%	5,91%	3,90%		6,63
JPMorgan EMU	69,97%	3,85%	0,99%	0,97	7,30
JPMorgan EMU ECB Weighted	77,23%	3,78%			7,31

Source: Own calculations based on market data.

The EMU basket would thus provide a diversified and ‘stable’ asset, and one that could be more liquid than many national bonds, especially of the smaller countries whose markets are often rather illiquid. Large banks would be able to mimic this basket themselves by holding the underlying bonds directly in the appropriate proportion. But this would require considerable trading and monitoring efforts, and the end result would in any event be the same, namely appropriate risk diversification.

The EMU basket would, of course, not solve all the problems. If investors lose confidence in an individual member state they might want to avoid holding the EMU basket because of the reputation effects. This is why many regulated entities, especially those with a retail base, sold all of their Greek exposure prior to the PSI (private sector involvement), regardless of price, since they wanted to be seen as not having any Greek exposure at all. Some banks might thus

⁴⁴ The weights in the JP Morgan EMU index are adjusted on a monthly basis and have changed considerably over time, compared to those of the ECB, which tend to change much less. In the JP Morgan EMU index, the weight of Germany has fallen from 24% in 2004 to about 17% today (whereas that of Spain has increased by an almost equal amount). By contrast, the weight of these two countries in the ECB capital key has remained rather stable at around 25-26% for Germany and 13% for Spain.

sell the basket (this would have no impact on the spreads *per se* since they would implicitly sell all sovereigns at the same time) and buy only those sovereigns still considered ‘safe’.

However, if they want to keep their overall sovereign exposure (e.g. to satisfy a liquidity requirement, see below), this would not be easy to achieve. Those banks selling the basket would then have to buy a number of other sovereigns separately since each individual sovereign would remain limited by the large exposure rule. The existence of the EMU basket would thus not solve the problem of such a ‘flight from trouble’, but it would make it somewhat less acute, since the exposure would be hidden in a product that has been certified as diversified. Moreover, in an efficient market, selling early would not, on average, lead to a better performance: as the prospect of a default comes closer, the market price would decline in any event in a corresponding manner. Even when default becomes a real possibility, the existence of the EMU basket could thus have a non-negligible stabilising impact.

Diversification is, of course, not a free lunch. The EMU basket would transmit shocks in any individual country, on a pro rata basis, to the entire euro area banking system. But this is the desired effect. Experience has shown that the social cost of a large shock to any individual country is much higher than a smaller shock hitting all countries at the same time.

Do banks need a ‘safe’ asset?

The European Commission (2017) has argued in its recent reflection paper on EMU that a diversification of the sovereign risk should only be considered if the banks are offered a ‘safe asset’.

However, it is difficult to see the link between the need for diversification and the existence of a safe asset. The underlying argument seems to be that a safe asset is needed to prevent a flight to safety (Bunds) leading to large risk spreads. But here again the existence of a safe asset *per se*, would not provide a solution. The key question is how elastic would the supply of this asset be. The easiest case to think of is that there might be a certain amount of Eurobonds around. These bonds would be guaranteed, joint and several, by all member states and thus be considered safe. What would happen then in case of a flight to safety? Since the available amount of the safe asset is fixed in the short run, investors who are seeking safety would still bid up the price of German government debt, and the price of the debt of weaker governments (or those only perceived as weaker) would fall. The price of the safe asset might also increase, but otherwise the divergence in interest rate would not be much different from the one observed during the euro crisis.

There is a large literature on the importance of a safe asset (see Grosse-Steffen, 2014, for a recent survey, which did not come to any definite conclusion). Portes (2013) points out that no asset is absolutely safe – as evidenced by the price of CDS (credit default swaps), which at times was non-negligible even for the US government) and that ratings provide a very imperfect guide to safety.

At any rate, even those, who argue that a scarcity of safe assets is a problem (Gourinchas and Rey, 2017) do so mainly in a longer-run perspective, looking at the incentives to issue too much of the safe asset. Moreover, there is little in the literature on safe assets that suggests that banks in particular have a need for a safe asset.

Holding sovereign debt for regulatory reasons?

One could argue that banks hold large amounts of (tradable) government debt on their balance sheets because of stringent rules on the amount of liquid assets they must have at their disposal to be able to face any sudden shortage of liquidity. These rules,⁵ which are gradually coming in force now, are embodied in the liquidity coverage ratio (LCR), which forces banks to have enough liquid assets to cover the cash needs that could rise under certain standardised scenarios of a withdrawal of deposits and other events requiring cash in hand. Banks can satisfy the LCR in principle using any asset that can be quickly converted into cash. But in reality banks usually rely on so-called ‘level 1’ assets, which are defined as having at least a rating of AA+.

Liquid assets are defined generally in EU regulation as assets that can be converted to cash without a loss of value. This would seem to encompass many different types of assets, but in practice banks prefer to hold government bonds because holding any other asset (with a rating below AA+) would lead to higher capital requirements and/or hair-cuts. This preference of highly rated assets in the liquidity regulation does not make sense. Safe assets are also defined as ‘information insensitive’. They should thus have in general a more stable market value. For example, during the euro crisis, the market value of Italian government bonds was higher than that of German bonds. But the preference for safety leads *de facto* to a discrimination against diversified assets whose market value can be even more stable than a safe asset. The ratings thresholds in the LCR regulations should thus be eliminated, and be substituted by a link with the stability of the market value. For example, the haircuts to be applied to the holding of assets could be linked to their volatility in such a way as to ensure that, over the period that forms the basis for the calculation of the potential maximum liquidity needed, it is highly unlikely that their market value falls so much that the liquidity needed could no longer be covered.

The preference for safe (or rather highly rated) assets in the existing liquidity regulations is the key reason why over one-half of the total liquidity held by banks is in the form of government bonds (a large part of the remainder is in central bank deposits).

Unfortunately, it is not possible to calculate how much liquidity banks have to hold to satisfy the LCR. The EBA has recently published country-level data on the overall amount of liquidity (which counts towards the LCR), but the data on what amount would be necessary to satisfy the LCR and what is in excess have been withheld for ‘confidentiality’ reasons. This is difficult to understand, especially for countries with many banks: with aggregate country-level data on

⁵ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061&from=EN>

‘excess liquidity’, it would in any event be impossible to know the liquidity situation of any individual bank.

However, a rough estimate of the part of sovereign holdings that are not needed for liquidity reasons can be obtained by comparing sovereign bond holdings across countries. Figure A1 in the Annex shows that (domestic) government debt securities holdings are only 2% of assets in Germany, against 10% in Italy. This suggests that a large part of the government holdings of Italian banks may not necessarily be needed to satisfy regulatory liquidity requirements.

The large bond buying programme of the ECB (or quantitative easing) since 2015 has led to a huge increase in the (excess) reserves of banks. As central bank deposits are also level 1 assets, banks could now probably satisfy a large proportion of their liquidity requirements with the over €1,000 billion of excess reserves they have accumulated.

Banks as buyers of last resort for government bonds?

It is often argued that banks should be allowed to buy large amounts of their own sovereign because this would allow them to stabilise the market in a crisis. But there are two reasons why banks’ purchases of their domestic governments’ bonds cannot have a large positive impact on bond prices (see Gros, 2017).

First of all, sovereign debt holdings by banks should not be regarded as an additional demand for public debt. Banks are just intermediaries for private savings. Any sovereign debt on the balance sheet of a bank could also be held directly by households (as long as it is in the form of a tradable instrument). The disadvantage of banks holding a substantial proportion of public debt is that they are leveraged, which multiplies the potential impact of any loss of value of sovereign debt on the economy (the famous diabolical loop). Governments should make it more attractive for households (and other real money investors) to hold government debt directly. Getting banks out of the business of financing the government would reduce overall leverage in the economy and would help to downsize the European banking sector in general (see ASC, 2013). The example of the US, where banks do not hold significant amount of public debt, shows that there is no need to rely on banks to support a large debt level.

A second reason why large bond-buying by banks cannot be expected to stabilise markets is that the funding cost for banks is usually higher than that of the sovereign (at least for market instruments, like bank bonds). Ratings agencies usually have a rating limit for corporates headquartered in a country, which is given by the sovereign rating. Another reason is that ratings agencies (and investors in general) expect the home government to stand behind its banks when they experience difficulties (the recent experience with the Venetian banks shows that this remains the case even under the new ‘bail-in’ regime).

A look at the data confirms that banks seldom have a lower funding cost than their own government.⁶ This fact has an important implication: the interest margin on government bonds must be negative. In turn, this means that one cannot argue that banks buying their own sovereign debt can stabilise the market. On the contrary, if an intermediary with higher funding costs than the sovereign buys sovereign bonds, the overall cost can only increase. This is indeed what happened in Italy when banks were issuing their own bonds at cost several percentage points above the cost of the Italian government and then bought large amounts of BTPs (Italian government bonds). The negative carry was considerable and must have weakened the banks further, thus aggravating the crisis instead of mitigating it.⁷

It is not a straightforward exercise to compare (senior) bank bonds with government paper because banks bonds are issued less frequently and have a shorter maturity than the standard (government) bond indices. Figure 2 below therefore shows the difference in the synthetic yields⁸ calculated from the sum of CDS on Italy's two largest banks plus swap rates (relative to Italian government paper of similar duration (5-year BTPs)). It is apparent that the banks are paying almost always more on their own securities than the government. Moreover, during crisis times, the difference in yields reaches even 100 basis points. The average for the period considered here is around 50 basis points. This implies that holding government bonds financed with bank paper yields substantial losses over the long run.

Even a cursory look at the funding structure of Italian banks shows the importance of this argument: Italian banks have over €500 billion in bonds and other debt instruments outstanding and they hold a little over €400 billion in bank bonds. Given that, as documented above, the cost of the bank bonds is higher than the return on government paper, this means that the banks would be better off reducing their bonds outstanding and getting rid of their government bonds. The net demand for government bonds would not need to fall as the same savers who now hold bank bonds in their portfolios (mostly 'administered' by the banks) could hold government bonds instead.

Finally, one has to distinguish between *ex ante* and *ex post*. When a bank has large exposure to its home sovereign, it will be affected deeply when a new crisis starts, as the value of the bonds on its balance sheet will fall. The regulatory capital position might not be affected since government debt can be held until maturity so that its market value does not enter into the calculations for the regulatory capital requirements. But market participants can make their own calculations and will in general mark down the value of the bank's equity on the basis of

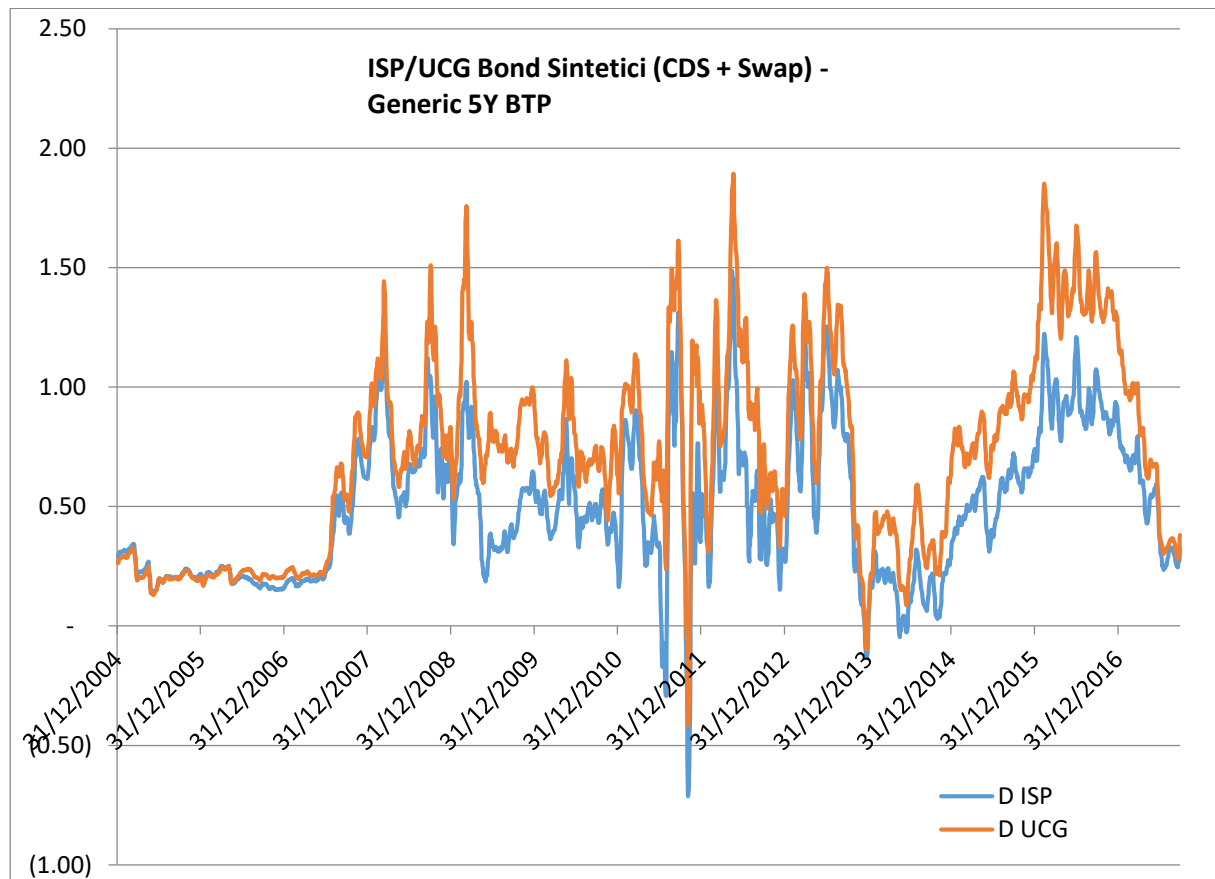
⁶ In the case of Greece, the opposite turned out (*ex post*) to be the case: holders of bank debt (mainly deposits, but also some bonds) were repaid in full, whereas (private) holders of government bonds suffered a large loss during the PSI operation of 2012. In a crisis, bank debt thus turned out to have been senior to sovereign debt.

⁷ It is of course true that the Italian banks made (*ex-post*) considerable losses on their lending to the economy, but had a positive return on government bonds. But this argument is irrelevant if one considers the choice, at the margin, for a bank to issue its own bonds (at a spread to BTPs) and buy more BTPs. This was, at the margin, a loss-making operation with close to certainty.

⁸ Comparing a concrete longer-term bond outstanding over the entire period yields a somewhat different picture: the average difference to BTP is somewhat lower, but the difference is larger during the crisis period of 2011-12.

mark-to-market losses. It follows that the country would be less affected by financial stress if at the start of a crisis its banks are holding little domestic public debt. It would thus be desirable to reduce the existing large exposures to domestic public debt, even if one follows the argument that banks can become the buyers of last resort for public debt in a crisis. The less banks hold at the beginning of the crisis, the more they would be able to buy.

Figure 2. Differences to BTP in the synthetic yields on bonds of Italy's two largest banks, 2004-16



Source: Eurizon Capital SGR.

Conclusions

Banks in the euro area hold large amounts of sovereign debt on their balance sheets. This creates well-known risks as it links the fate of the banks to that of their sovereign. De-risking banks should proceed along two lines. One way to address this problem would be to create a 'safe' asset. But creating a safe asset requires some financial engineering (e.g. tranching), as in the recent Commission proposal. Moreover, the tranching process itself also creates assets (the junior tranches) that carry more risk. Moreover, the tranching process itself considerably reduces the attractiveness of the resulting 'government bond-based securities'.

The insistence on the need for a safe asset might be misplaced, however, since the real issue for banks is to have at their disposal a liquid asset whose value is stable. A totally safe asset can

have a less stable market value than a simple portfolio of several assets, each of which might not be totally safe.

A first step would be to stop discriminating against diversification via investment funds, which bundle euro area government debt. Such funds already exist in large numbers with different characteristics in terms of maturity and degree of coverage of the euro area. They rely on a globally recognised legal framework with wide market acceptance. But banks do not hold these funds because even a fund whose underlying securities consists only of euro securities would be subject to a capita charge and would not be regarded as liquid. This does not make sense and should be changed.

Moreover, the authorities could also encourage banks to diversify risks by offering them a diversified asset, which, while not AAA-rated, would have a more stable value than individual sovereign bonds. This could be achieved by giving ETF-type investment funds, which invest in a weighted average of euro area government bonds, the status of 'diversified asset', which could then be excluded from the application of the large exposure Directive.

In the long run, governments should make it more attractive for households and other real money investors with a long-term horizon to hold government bonds directly. This would reduce economy-wide leverage. Many banks hold large amounts of government bonds in order to be able to cover unanticipated liquidity needs. Liquidity requirements for banks should not favour government debt. Any asset that can be sold on short notice should be considered useful under the liquidity cover ratio (LCR).

The present environment is very favourable for advancing on both of these proposed fronts.

The overall savings surplus in the euro area means that there should be no need to rely on banks to find investors for the existing government debt (and the declining deficits in some countries).

The Public Sector Purchase Programme of the ECB has already effectively created vast amounts of a 'safe asset', namely central bank deposits. Excess reserves are already above €2,000 billion and are growing, as the PSPP continues. This should allow banks to satisfy their liquidity requirements without holding too much sovereign debt. Given that the ECB is unlikely to start selling its vast stock of bonds any time soon, it could easily cover a larger part of the maturity spectrum by also offering longer-term deposits. The argument that banks cannot diversify their sovereign risk because they need a safe asset is thus less and less valid.

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Figure A1. Domestic government debt securities held by domestic banks

