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## Government Funding Privileges in European Financial Law

van Riet, Ad

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**GOVERNMENT FUNDING PRIVILEGES IN EUROPEAN  
FINANCIAL LAW: MAKING PUBLIC DEBT EVERYBODY'S  
FAVOURITE?**

By

Ad van Riet

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# GOVERNMENT FUNDING PRIVILEGES IN EUROPEAN FINANCIAL LAW: MAKING PUBLIC DEBT EVERYBODY'S FAVOURITE?

Ad van Riet \*

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## Abstract

Since the global financial crisis of 2008 European authorities have set out to strengthen financial governance in order to create a more stable and resilient financial system. As discussed in this paper, the new and updated EU legislation addressed at a wide array of financial markets and institutions also significantly broadened the scope of the existing preferential regulatory treatment of sovereign bonds and introduced new funding privileges for governments. The many regulatory incentives for investors to buy and hold (domestic) government debt facilitate public debt management, at the cost of crowding out private sector funding and raising financial stability concerns every time the government faces distress. Moreover, a privileged access to capital markets reduces market discipline and may lead to moral hazard on the part of sovereigns. The growing scope of these government funding privileges in EU financial law may be interpreted in three (complementary) ways: as a revival of financial repression in a modern prudential guise to reduce the burden of high public debt, as a return to the traditional close relationship between the government and the financial sector so as to align mutual interests in fiscal and financial stability, or as a way to increase explicit and implicit taxes on finance and recoup public revenues lost during the financial crisis. The preferential treatment of sovereign exposures and governments' market access is found in a growing body of EU financial law. Regulatory efforts to reduce it would have to be coordinated at the international level, take account of the financial structure and allow for a (long) period of transition to avoid market disruption.

JEL classification: E44, F3, G18, G28, H63.

Keywords: European financial reform, financial repression, regulatory capture, financial stability.

\* Tilburg University (Netherlands) and European Central Bank (Germany). E-mail: [ad.van\\_riet@ecb.europa.eu](mailto:ad.van_riet@ecb.europa.eu).

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*[T]he current prudential treatment of sovereign exposures is no longer tenable ... prudential regulation is a useful complement to sound public finances, but not a substitute for them.*

BIS (2016), 86th Annual Report 2015/16, pp.92-93.

## **1. Introduction**

Responding to the global financial crisis of 2008, the leaders of the Group of Twenty (G20) major economies, including the European Union (EU), committed to restoring the health and stability of the global financial system (Group of Twenty, 2008). They responded by tightening regulations, stepping up supervision and putting in place more effective bank resolution regimes and took steps to counter excessive speculation and irrational market forces.

Following the G20 initiatives, the competent authorities in the EU set out to correct financial market failures, tighten financial regulation, enhance financial supervision and improve the resilience of financial institutions in Europe. The European Commission (2010a, 2014b) implemented a comprehensive financial reform programme with the overall objective to create a more resilient and growth-supportive EU financial system and to secure financial stability. This supranational intervention may be viewed as a public policy response to legitimate growth, stability and distributional concerns associated with market, institutional and regulatory failures. As discussed in the paper, the reform of European finance went further than just removing financial market distortions, correcting deficient regulations and strengthening supervisory institutions: it also significantly widened the scope of the existing preferential regulatory treatment of sovereign debt that makes it easier for governments to obtain market funding at favourable interest rates and to manage the crisis legacy of high public debt. The broadening base of this 'regulatory tax on finance' has largely escaped attention.

First, the authorities have set out to tighten EU prudential legislation for banks as well as for money market funds, investment funds, institutional investors and central counterparties. As a result, the existing preferential treatment of claims on the government in banking legislation has gained in weight and has been extended to other financial services. This regulatory feature encourages the financial industry to disregard the risks from high government exposures and contributes to captive sovereign credit markets. Second, EU financial market legislation has been tightened in several respects, notably affecting credit rating agencies, short-selling and credit default swaps. Several aspects of these legal changes reduce market

pressure and benefit governments in times of funding stress. Third, many euro area countries are considering how best to impose a harmonised financial transactions tax. Governments could well decide to exempt market trading in sovereign bonds, thereby favouring public debt management in addition to receiving extra tax revenues.

European policymakers may have felt compelled in this respect to follow where relevant parallel regulatory developments in other advanced economies, notably the United States. Beyond this political desire for a ‘level playing field’, the extension of market access support for governments in EU law may be related to three (complementary) political economy explanations.

First, this finding could signal the revival of ‘financial repression’, i.e. a comprehensive regime of government interventions in the financial system with the intention to extract economic rents and to gain fiscal benefits (Reinhart, 2012; van Riet, 2013). A common feature of financially repressed systems is that government bond prices are distorted by non-market players and regulation (Reinhart and Rogoff, 2011). Lorenzen (2012, p.3) also sees a “distinct leaning in recent policy towards gradually creating a captive buyer base that can hold more of sovereign debt through voluntary or coercive means”. This political dominance over finance to facilitate government funding may create a bias towards debt-financed public spending.

Second, the new government funding privileges in finance could reflect the need to redefine the existing relationship between the state and the financial sector. Monnet et al. (2014) interpret the additional restraints placed on the financial industry as a return to historical patterns, whereby governments and market participants exercise mutual pressure and try to influence each other in order to gain special advantages. The stronger role of the state in finance is necessary in order to stabilise public finances in a more volatile financial market environment, in the interest of all players in this political game. Taking this view, a preferential regulatory treatment of public sector versus private sector debt securities reflects the importance of preserving the role of government bonds as safe and liquid assets as a precondition for a stable financial system.

Third, the introduction of new explicit and implicit taxes on finance may respond to the perception that governments were under the influence of regulatory capture by the financial industry and political pressure from banking sector lobbies to reduce their fiscal and quasi-fiscal burden. This enabled leveraged international banks to enjoy large profits, while the

crisis costs of bank resolution were socialised. For reasons of tax fairness, the financial sector should return this government support and in future make a larger contribution to public revenues and resolution funds (see IMF, 2010; ESRB, 2012, 2014; Chaudry et al., 2015; Devereux et al., 2015). Moreover, financial markets and services could serve as a vehicle for increased implicit taxation of the private non-financial sector. To ensure the effectiveness of the related financial sector taxes and to prevent tax arbitrage in a setting with open capital markets, they should be introduced at the European level.

Enabling governments to protect themselves from market pressure may be understandable given the heavy fiscal legacy of the crisis, the systemic role of government bonds as safe and liquid assets and the view that the financial sector should in future make a larger contribution to the European tax bill. This may offer national governments some compensation for the fact that their ability to exercise political dominance over the domestic financial industry and capital markets in general is being constrained by two recent developments: first, the recent centralisation of banking supervision and resolution under the European Banking Union, and second, the planned harmonisation of capital market law as part of a Capital Markets Union (Véron, 2012; 2014).

However, extensive government privileges in public debt financing create moral hazard on the part of sovereigns and undermine incentives for fiscal adjustment and economic reforms. They put a heavy burden on the successful implementation of the reinforced EU economic governance framework that seeks to ensure sound macroeconomic and fiscal policies (see Koester et al., 2012; Kamps et al., 2014). Moreover, the regulatory bias towards large sovereign exposures in financial institutions may become an economic and prudential concern, given the possible crowding out of private sector funding and the risks for financial stability in times of fiscal stress (see also ESRB, 2015). At the international and European level discussions are currently ongoing on whether, how and in what pace to phase out these provisions in prudential banking legislation. The evidence in this paper shows that an encompassing approach is warranted, taking account of the risk of regulatory arbitrage.

This paper is structured as follows. Section 2 briefly reviews the post-war changes in the governance of finance in Europe. EU countries opened up financial markets, introduced common prudential legislation to supervise the financial industry, and became more dependent on capital markets for their funding needs. Section 3, 4 and 5 document the main cases where the crisis-driven overhaul of European financial governance over the period 2008-2016 is leading to a (further) preferential treatment of sovereign debt in banking,

investment and market law, respectively.<sup>1</sup> While the result is a fairly extensive overview of government funding privileges appearing in (proposals for) EU regulations and directives, the paper concurs with Reinhart and Sbrancia (2015, p. 322) that such a “list is barely the tip of the iceberg, as volumes would be required to fully capture all that has been turned into law – let alone what has been and continues to be discussed”.<sup>2</sup> Section 6 concludes that the financial reforms undertaken are vital in order to make European finance more resilient and less prone to adverse shocks, but that the growing number of government funding privileges may fuel moral hazard on the part of sovereigns.

## **2. Changes in the governance of finance in Europe**

The first decades after World War II saw many advanced economies, also in Europe, applying pervasive financial restrictions. The rationale for such government interventions was the perception that policy-makers could not rely on the free functioning of financial markets to achieve public policy objectives (van Riet, 2016a). Moreover, it helped governments in managing and reducing their very high post-war public debt ratios (Reinhart and Sbrancia, 2015). However, the public sector interventions distorted private saving and investment decisions, hampered the efficiency of financial intermediation and triggered evasive action to escape the implicit taxation and diversion of private returns.

After the breakdown of the Bretton-Woods exchange rate system, it became ever-more difficult to maintain the pervasive restrictions on the financial system. Over the course of the 1970s-1980s, financial markets in advanced economies were widely liberalised, capital controls were progressively lifted, central banks gained legal independence in the conduct of monetary policy and public debt management was often operationally separated from fiscal and monetary policy. On the European continent this process mostly occurred at a relatively late stage, in preparation of the changeover to the euro (Wyplosz, 2001).

This evolving trend had at least two consequences for governments: first, they had to introduce prudential regulation and supervision of the financial sector to protect savers and

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<sup>1</sup> This review focuses on regulatory privileges for EU sovereigns (central governments) while it acknowledges that in many cases similar advantages apply to the central bank, regional and local governments, public sector entities, multilateral institutions and third country governments. Moreover, many EU financial laws are of relevance for the whole European Economic Area.

<sup>2</sup> For example, EU directives also make it possible to grant European sovereign debtors specific privileges with regard to the initial public offering of their securities, disclosure requirements for listed securities and the preservation of market integrity. These EU provisions allow Member States in particular to exempt sovereigns from the obligation to publish a prospectus and from regular financial reporting requirements, and to exempt public debt management transactions from the rules against insider dealing and market manipulation. These sovereign privileges are discussed by Kersting (2012) and not covered in this study.

investors and preserve systemic stability (Masciandaro and Quintyn, 2013); second, they had to pursue credible stability-oriented economic policies in order to convince market participants that they were creditworthy so that they could attract savings at affordable, market-determined (real) interest rates (van Riet, 2013).

Gelpern and Gerding (2016) observe in this light that the law plays an important role in making investors believe that specific assets are safe. Beyond the core powers of a nation state to access the country's resources, national policymakers use their powers of legislation, regulation and contract design to coordinate market participants towards selecting the sovereign benchmark asset promoted by law and to act as if it was safe, even if reality is different. Governments greatly facilitated meeting their new challenge of financing public debt in open capital markets by making sure that the prudential requirements for financial intermediaries, notably banks and institutional investors, would not impose any restrictions on their holdings of domestic sovereign debt. Accordingly, they labelled government bonds as 'safe' for regulatory purposes.

Also supported by favourable credit ratings and the absence of defaults, markets thus generally perceived the sovereign bonds of advanced economies as 'safe' assets and over time these functioned as a cornerstone for the development of the financial system (IMF, 2012; Castro and Mencía, 2014; van Riet, 2016b). As a 'risk free' financial instrument they served inter alia as a high-quality liquid asset on bank balance sheets for meeting prudential standards, a stable store of value for institutional investors, a reliable form of collateral in repurchase and derivatives markets as well as for central bank refinancing operations and payment and settlement systems, and as a benchmark for pricing private sector securities. The growth of government bond markets in fact underpinned the rapid global expansion of financial markets and financial institutions in recent decades, with international regulatory coordination and supervisory cooperation struggling to keep pace.

After the global financial crisis of September 2008 many observers have argued that financial liberalisation had made the financial sector more prone to risk-taking behaviour, blaming light-touch regulation and lax supervision for accommodating the growing fragilities in the financial system. As stated by the European Commission (2014b, p.3) “[p]olicymakers, regulators and supervisors around the world failed to identify and adequately address the risks building up in the financial system”. Arguably, supervisory agencies were subject to regulatory capture by the financial industry and eschewed precautionary action. A combination of market failures, regulatory deficiencies and supervisory forbearance enabled

international banks to take on too much leverage and the private non-financial sector in many countries to accumulate an unsustainable mountain of debt. Moreover, ‘too-big-to-fail’ systemic banks took too many risks in their hunt for higher yields and still many of them succeeded in passing their rescue bill on to taxpayers (IMF, 2014).

This motivated a newly empowered G20 to strengthen financial markets and remedy the shortcoming of regulatory regimes so as to avoid future crises. At the Washington Summit of 15 November 2008, the leaders of the G20 established common principles for the reform of financial markets and an action plan (Group of Twenty, 2008). Following the G20 initiatives, the competent authorities in the EU set out to correct financial market failures, tighten financial regulation, enhance financial supervision and improve the resilience of credit institutions in Europe. The European Commission (2010a, 2012, 2014b) embarked on a comprehensive financial reform programme with the aim to make the financial sector “more stable, more responsible, less speculative and less short-termist, and more oriented towards long-term growth” (European Commission, 2012, p.23). The overall objective of this overhaul of the governance of finance in Europe is to create a more resilient and growth-supportive EU financial system and to secure financial stability. However, this comprehensive policy response also significantly broadened the scope of the existing preferential regulatory treatment of sovereign bonds.

To highlight the evolution over time, van Riet (2015) constructs composite legal indices, covering the preferential treatment of sovereign debt in new EU financial legislation introduced over the period 2008 to 2015. He finds that the array of regulatory favours for euro area governments in European finance has increased significantly, in particular for euro area countries. A further rise will occur when already adopted and still pending EU legislation takes effect, before it peaks in 2018 and then declines slightly due to a modest scaling back of these fiscal favours.

Looking beyond the wish to coordinate financial reforms at the global level, this remarkable development may reflect at least three (complementary) political economy considerations.

First, the wider reach of government funding privileges can be interpreted as a financial repression strategy to facilitate public debt management. One may argue that the Treaty on the Functioning of the European Union (henceforth: ‘EU Treaty’) offers little scope for a revival of market access support for governments, given that the prevailing ‘fiscal rules of the game’ force them to finance public debt in open capital markets and hence subject them to

market discipline. Moreover, the establishment of the European Banking Union with its centralised banking supervision and resolution mechanisms has taken away many of their domestic levers for financial repression (Véron, 2012). Europe's plans for a Capital Markets Union entail a similar threat to the ability of national authorities to repress domestic capital markets and the non-bank financial sector (Véron, 2014). However, the quest for a more resilient financial system may still contribute to ring-fencing governments against market pressure. The associated market distortions may find acceptance, notably under the guise of changing EU prudential legislation (Reinhart and Rogoff, 2011).<sup>3</sup> Taken together, this could signal that in conjunction with the crisis response a modern supranational form of financial repression is resurfacing with the objective to ease the burden of high public debt.

Second, governments may be seeking to restore a mutually beneficial relationship between the public sector and the financial sector. Monnet et al. (2014) point to the rising share of sovereign bonds on the balance sheets of financial institutions, the growing importance of public credit institutions in providing long-term financing to the economy, and the active role of the European Central Bank (ECB) in preserving both monetary and financial stability. They interpret this changing financial landscape as a reactivation of the multi-faceted interactions between governments and their financial systems that were predominant until the 1980s; these served, inter alia, to facilitate economic adjustment and maintain financial stability. Against this background, preserving the benchmark role of government bonds as safe and liquid assets may be seen as vital to the stability of the financial system.

Third, for reasons of tax fairness, the financial sector could be expected to make a larger contribution to public revenues. As pointed out by Huizinga (2004), EU countries in the past have tended to subsidise domestic banks using tax, regulatory and supervisory instruments to offer them a relief from the high explicit and implicit levels of taxation in economies with a repressed financial system. This balance was disturbed as the liberalisation of the European banking sector and the introduction of the euro forced governments to reduce the net fiscal and quasi-fiscal burden on domestic banks facing heightened international competition to an unduly low level. The strong policy competition among Member States resulted in extensive tax and cost benefits, light-touch regulation and lax supervision. Responding to the financial

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<sup>3</sup> The EU Treaty (Article 124) explicitly states that “[a]ny measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited”. Council Regulation (EC) No 3604/93 further specifies: “Whereas ... prudential considerations may justify departure from the principle of this prohibition; ... laws, regulations or administrative actions may not, however, under the cover of prudential considerations, be used to establish disguised privileged access”.

crisis European governments not only seek to redress apparent market, institutional and regulatory failures; they also wish to recoup foregone tax revenues and cut implicit subsidies by introducing financial sector taxes and removing quasi-fiscal advantages in financial legislation.

The freedom of financial markets and institutions will in any case be more constrained in the future than before the crisis. As discussed in detail below, a significant number of the financial reforms undertaken at the European level to prevent a repetition of the financial crisis also show a tendency towards facilitating capital market access and debt financing for the public sector (see Table 1 for the 10 main legislative measures of 2008-2016 selected for this paper; see Annex Table for a detailed overview).

**Table 1 – Selection of main European financial reforms 2008-2016**

Main reforms of EU financial legislation	De facto date of announcement	De jure date of application	Status of legislative process
1. EU banking regulation/directive (CRR/CRD IV)	July 2011	Jan 2014	In force, phased in
EBA capital exercise	Oct 2011	Oct 2011	Ad hoc measure, repealed Dec 2014
2. EU banking structure regulation	Jan 2014	Jan 2017/ Jan 2018	Under discussion
3. EU regulation on money market funds	Sept 2013	Jan 2017	Under discussion
4. EU investment funds directive (UCITS IV)	July 2008	July 2011	In force
5. EU insurance and reinsurance directive (Solvency II)	Mar 2008	Jan 2016	In force
6. EU directive for occupational pension funds (IORP II)	July 2010	-	Deferred in May 2013
7. EU market infrastructure regulation (EMIR)	Sept 2010	Aug 2012	In force
8. EU regulation on credit rating agencies	July 2011	June 2013	In force
9. EU regulation on short-selling and CDS contracts	Sept 2010	Nov 2012	In force
10. Common financial transactions tax (FTT)	Feb 2013	Dec 2016	Under discussion

Source: Compilation based on (proposed) changes in European financial law 2008-2016.

### **3. The preferential treatment of government debt in EU banking law**

#### *3.1 EU prudential banking legislation*

A privileged market access for governments based on prudential considerations can be found already in the Basel Accord of 1988. This agreement among the Group of Ten (G10) major

economies determined the supervisory regulations governing the capital adequacy of international banks based on the weighted relative riskiness of broad categories of assets, focusing on credit risk. One of the contentious issues was how to treat bank claims on foreign governments relative to those on the domestic government which were deemed to be ‘safe’.<sup>4</sup> As documented by Goodhart (2011, p.154; 2013, p.243), Europe insisted to apply the basic principle of the EU Treaty that all Member States should be treated equally and enjoy the same high credit standing, which should translate in a zero credit risk for bank claims on all EU sovereigns. To allow for an equal assessment of sovereign instruments among the ‘club’ of G10 members and other advanced economies, the Basel Committee on Banking Supervision then decided to extend the preferential treatment of sovereign exposures by default to those vis-à-vis all OECD countries.<sup>5</sup> As observed by Goodhart (2011, p.159) true economic risk played no role in this decision, but it was the only way to reach an agreement on the subject.

The revised framework of Basel II introduced a significantly more risk-sensitive framework based on two credit rating approaches: a standardised one and another based on banks’ internal risk models. OECD membership was thus no longer a sufficient condition for sovereign claims to attract a zero risk weight. However, national authorities were given the choice to give bank claims on the sovereign a preferential zero-risk treatment if certain conditions were met.

At the European level, the Basel Accords I and II found their way in successive versions of the Capital Requirements Directive (CRD), which were transposed into national law of the Member States for supervisory application to credit institutions and investment firms. These EU directives essentially considered government securities as ‘safe’ assets by definition, irrespective of credit, market and concentration risks (Kopf, 2011).

For banks located in a euro area country the changeover to the euro in 1999 implied a substantial increase in the effective scope of the preferential regulatory treatment of sovereign exposures. Before 1999, their focus was on holding own government bonds because exchange rate risk still acted as a barrier to their cross-border investments in debt securities

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<sup>4</sup> The idea was that a sovereign can always meet its nominal payment obligations by issuing more of its own currency. This argument raised questions for those countries where the central bank was independent and later for the member governments of the euro area where debt monetisation by the ECB was excluded by law. See also BIS (2016, p.90).

<sup>5</sup> More precisely: all full OECD members or countries which had concluded special lending arrangements with the IMF associated with the Funds’ General Arrangements to Borrow (the club was subsequently extended to include those countries having signed the New Arrangements to Borrow). Later it was added that any country which reschedules its official external debt is precluded from this group for a period of five years. For details see Goodhart (2011, Chapter 6).

issued by other prospective euro area central governments – even though central government debt from all OECD members attracted a zero-risk weight. After the inception of the euro, these banks could buy the central government bonds of other countries in the eurozone not only without having to worry about extra capital charges for lower-rated sovereigns but also without having to accept exchange rate risk. As their claims on individual governments were furthermore exempted from the large exposure limit that applied to private assets, they enjoyed a regulatory incentive to diversify their country risk and ‘hunt for yield’ across the whole eurozone (see also McCauley and White, 1997).

Following the global financial crisis, tighter Basel III standards were approved by the G20 in November 2010 and published by the Basel Committee on Banking Supervision one month later. The EU Capital Requirements Regulation (CRR) and update IV of the Capital Requirements Directive (CRD IV) transposed these new international standards into EU law; they entered into force in July 2013 and took gradual effect from January 2014 with full implementation to be achieved within five years (European Union, 2013c,d). Their overall aim is to strengthen the quantity and quality of bank capital, limit large capital exposures, ensure liquidity, promote stable funding and constrain leverage. This revamped EU prudential banking legislation contains several important cases of a preferential treatment of bank claims on the government, some of which will be limited over time while some others are additional compared to those in the earlier CRDs.

### *Capital adequacy*

According to the Basel II and III agreements, banks must hold a minimum amount of capital against the credit risk of all their exposures in the banking book, including their sovereign exposures. Two methodologies may be adopted: the standardised approach, which relies on external credit ratings; and the internal-rating based approach, which relies on (large) banks’ own risk assessment models. Under the standardised approach of the Basel II/III framework national authorities have the discretion to allow banks to apply reduced risk weights to their sovereign exposures (see BIS, 2013).<sup>6</sup>

The new EU regulation (CRR) grants, as before, a standardised zero-risk weight to exposures vis-à-vis the central government of any Member State if these are denominated and funded in

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<sup>6</sup> Note that sovereign claims held in the trading book also receive a reduced risk weight for specific market risks, notably for credit spread risk. The Basel Committee on Banking Supervision has undertaken a fundamental review of the capital requirements for securities held in the trading book. The new standards on the treatment of market risk in the trading book take effect from January 2019 and continue to allow banks to give a preferential treatment to sovereign exposures. The European Commission (2016) has put forward similar trading book rules for EU credit institutions, assigning exposures to all EU sovereigns always the lowest risk weights for credit spread risk.

the domestic currency. For banks in the eurozone, this preferential treatment covers by default their claims on all member countries of the European Economic and Monetary Union (EMU) if these are denominated and funded in the euro, since this is their relevant domestic currency. The standardised approach, as applied in the EU, also continues to extend the zero-risk weight to all EU sovereign exposures denominated and funded in any other EU currency than that of the issuing Member State, although after 2017 this transitional provision will be phased out. From 2020 onwards in these cases the assessment of external credit rating agencies will have to be followed (see Tables 2 and 3).

**Table 2 – Credit risk weights for exposures to central governments**

(standardised approach; ratings from nominated external credit assessment institutions)

<b>Credit quality step</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>unrated</b>
<b>External credit rating</b> (example S&P)	AAA, AA	A	BBB	BB	B	CCC and below	unrated
<b>Credit risk weight</b>	0%	20%	50%	100%	100%	150%	100%

Source: Final draft implementation technical standard prepared by EBA, EIOPA and ESMA (November 2015) between the long-term issuer credit assessments of Standard & Poor's and the credit quality steps under the standardised approach in line with the EU Capital Requirements Regulation, Articles 114 and 136 (European Union, 2013c).

**Table 3 - Regulatory capital treatment of bank claims on the government <sup>1)</sup>**

(EU prudential banking legislation - CRR/CRD IV; in percent of standard credit rating)

<b>Claims issued and funded in:</b>	<b>domestic currency</b>	<b>other EU currency</b>				
<i>Year of application:</i>	<i>permanent</i>	<i>2014-17</i>	<i>2018</i>	<i>2019</i>	<i>2020</i>	
<b>Claims issued by:</b>						
domestic government of a euro area country	0%	0%	20%	50%	100%	
government of any other euro area country	0%	0%	20%	50%	100%	
government of any other non-euro area EU country	0%	0%	20%	50%	100%	
government of any non-EU country 2)	0%					

Note 1): claims on EU governments include claims on central government and the central bank and may include claims on regional and local governments and in exceptional circumstance those on public sector entities.

Note 2): 0% on condition that the regulatory authorities have at least equivalent prudential legislation in place and give claims on their sovereign issued and funded in domestic currency a risk weight of zero; otherwise standard credit rating.

For euro area banks this forthcoming more realistic risk weighting of sovereign claims in non-domestic EU currencies is only of modest relevance; as mentioned above, banks based in the eurozone can automatically value all their euro denominated and funded exposures vis-à-vis EMU governments as zero risk claims (see also Angelini et al., 2014). This implies that for example the sovereign bonds issued by crisis-affected eurozone countries will continue to be treated as risk-free for all euro area banks. Goodhart (2013, p.244) critically describes this outcome as “patently ludicrous” (see also the views of Pomerleano, 2010; Kassow, 2010; Kopf, 2011; Ayadi et al. 2012; Nouy, 2012; Gros, 2013; Weidmann, 2013).

The Basel II/III framework allows banks using internal risk models to permanently adopt the standardised approach for assessing credit risk for non-significant business units and asset classes that are immaterial in terms of size and perceived risk profile. Going beyond this Basel II/III ‘carve out’, the EU regulation (CRR) permits such banks to apply the standardised approach to a wide range of sovereign exposures (covering the whole public sector of the Member States) – even those of material size and perceived risk – as long as they would be assigned a standardised zero-risk weight (see Nouy, 2012; BIS, 2013; Castro and Mencía, 2014; ESRB, 2015 on this so-called ‘permanent partial use’ of internal credit ratings). The EBA is required to issue guidelines at the latest in 2018 that limit over time the use of the standardised approach by banks that normally use internal ratings.

Overall, the zero-risk assessment applicable to all sovereign exposures in EU prudential banking regulation continues to be misaligned with the more differentiated views of markets and credit rating agencies regarding Member States’ fiscal fundamentals and their probability of default. This amounts to a preferential regulatory treatment of bank claims on the public sector relative to exposures vis-à-vis the private sector, which benefits in particular euro area governments. Since the EU bank capital requirements have been tightened with the implementation of Basel III, in terms of the capital definition, the capital criteria and five extra capital buffers for specific situations, the weight of this preferential treatment has increased even further. All else equal, this should be expected to further raise banks’ structural demand for these ‘safe’ sovereign assets.

According to the IMF (2012), the zero-risk weighting of domestic sovereign exposures contributed to an upward bias in the end-2007 capital adequacy ratios of banks (in terms of regulatory capital to risk-weighted assets) of 0.5 to 2.0 percentage points across European countries. This zero-risk regulatory bias has grown since the financial crisis, because fiscal fundamentals have deteriorated and many banks have increased their sovereign exposures.

Bonner (2016) shows the presence of this regulatory effect in a study of the Dutch banking sector over the period June 2009 to December 2012. Banks with a lower regulatory capital position significantly increased their demand for zero risk-weighted sovereign bonds shortly before the reporting date over and above their internal risk management targets while selling other, positive risk-weighted bonds. Korte and Steffen (2014; 2015) conclude that banks face a large contingent capital shortage due to the zero-risk treatment of their sovereign exposure, which increases potential public bailout costs, amplifies the negative sovereign-bank feedback loop and – through their holdings of non-domestic government bonds – fuels contagion across Europe. They estimate the size of this sovereign subsidy for 54 large European banks at EUR 750 bn. or almost 100% of their core (tier 1) capital as of June 2013, a figure which has almost doubled since end-2009 as actual credit risks on government debt deteriorated substantially.

Hannoun (2011) suggests that the regulatory authorities should move towards a more realistic assessment of sovereign risk and stricter capital requirements where necessary. Consistent with this advice, the European Banking Authority (EBA) issued in December 2011 a recommendation to the national competent authorities which sought to increase the transparency about unrealised losses hidden in the government bond portfolios of systemic banks. Large European banks were asked to create by mid-2012 an exceptional and temporary capital buffer against their fair valued sovereign exposures towards the countries belonging to the European Economic Area (EEA) and to raise in this connection their core tier 1 capital ratio to 9%. The EBA's capital exercise may be interpreted as de facto introducing realistic risk weights on the sovereign exposures of the participating large banks (Korte and Steffen, 2014; 2015). This prudential intervention sought to reassure markets about the banking sector's ability to absorb unexpected losses and remain solvent. National supervisors were in this connection asked to ensure that the necessary strengthening of banks' capital positions would not lead to an excessive pace of deleveraging, as this could aggravate the recession in affected countries. This could occur if in response to the capital exercise banks would sell a lot of their government bonds and/or significantly reduce the supply of credit to the economy.

Most large banks were able to fulfil the EBA's temporary capital requirements by mid-2012 (EBA, 2012). As a transition to the full implementation of the Basel III capital standards in EU law (CRR/CRD IV), the EBA adopted in July 2013 a new recommendation to preserve the enhanced level of bank capital. Also taking account of the market environment, the

additional capital buffer against sovereign risk thus remained in force, until the EBA recommendation was repealed in December 2014.

### *Liquidity coverage ratio*

The misalignment between regulatory and market-based sovereign credit risk in the EU's capital adequacy rules has been extended to the new EU liquidity and funding standards that follow the Basel III framework as published in December 2010 (see Nouy, 2012; Castro and Mencia, 2014; ESRB, 2015). Starting with liquidity, the CRR requires credit institutions and investment firms to hold enough unencumbered high-quality liquid transferable assets to cover their net cash outflows over a 30-day period of liquidity stress. Observance of this liquidity coverage ratio should increase the short-term resilience of banks against shocks that drain their liquidity.

A liquid asset is defined as “a freely transferable asset that can be converted quickly into cash in private markets within a short timeframe and without significant loss in value” (see European Union, 2015a, p.2). For certain types of liquid assets the market value used in the calculation of the liquidity coverage ratio is to be reduced by a specific haircut. A further differentiation is made between assets of extremely high liquidity and credit quality (so-called level 1 assets) and assets of high liquidity and credit quality (level 2 assets, which are further divided in level 2A and 2B). Pending specification of a uniform definition, the CRR stated that “at least government bonds ... would be expected to be considered assets of extremely high liquidity and credit quality” (European Union, 2013c, p.13).

The EBA (2013) conducted an empirical analysis to compile a ranking of different asset classes according to their liquidity. EU sovereign bonds issued in the domestic currency and with the highest credit quality (step 1 in Table 2 above) were indeed found to meet the criteria of assets of extremely high liquidity and credit quality. But sovereign bonds of a lower credit quality (step 2 in Table 2) only fulfilled the criteria of assets of high liquidity and credit quality. Adding its qualitative expert judgement, the EBA nevertheless recommended an equal treatment of all bonds issued or guaranteed by EU sovereigns and issued in the domestic currency as transferable assets of extremely high liquidity and credit quality. Their advice was motivated by the fear that a differentiation between European sovereigns could contribute to a fragmentation of the single capital market. Moreover, in a crisis there could be harmful mutual contagion between credit institutions and their sovereign (EBA, 2013, p.26).

This EBA recommendation was taken over in the European Commission's delegated act that specifies the details of the liquidity coverage ratio (European Union, 2015a). All claims on or guaranteed by the central government of a Member State gained level 1 status and count in full (without haircut) towards meeting the liquidity coverage ratio irrespective of the actual market situation. Furthermore, the rules state that liquid asset holdings must always be appropriately diversified per asset class. As another preferential treatment, sovereign-based assets with level 1 status enjoy an exemption from this diversification requirement. Credit institutions are allowed to hold them in their liquidity buffers without limit. Yet, the EU Treaty seeks to subject Member States' borrowing to market discipline based on their individual creditworthiness.

The oversight body of the Basel Committee on Banking Supervision endorsed in January 2013 a number of changes in the proposed liquidity rules for banks. The definition of eligible high-quality liquid assets was broadened with certain corporate debt securities, asset-backed securities and shares, subject to a higher haircut and limit. This should reduce the pressure on banks to hold for liquidity purposes sovereign bonds or marketable securities backed by governments, which in turn relaxes somewhat the close ties between banks and sovereigns. Following an observation period, the requirement for banks to comply with the liquidity coverage ratio will be phased in from 2015 to apply in full from 2019, similar to the capital requirements. This will give in particular the fragile banks more time to strengthen their balance sheets. Given the importance attached to a strong liquidity position, EU banking legislation set October 2015 as the starting date and a full implementation of the liquidity requirement already as from 2018.

The EBA Banking Stakeholder Group (2012, p.5) expects that banks will respond by prioritising investments in assets defined as 'liquid' and give lower priority to other assets. Again, this is likely to raise their demand for government bonds, since these are regarded as liquid by definition (see also IMF, 2012). Bonner (2016) studies the behaviour of Dutch banks in response to a liquidity requirement already set by the national regulator which was similar in design to the new EU requirement. He finds for the period June 2009 to December 2012 that Dutch banks facing a lower liquidity buffer than required indeed bought more government bonds shortly before the reporting day in order to comply with the national liquidity coverage rule.

Buschmann and Schmaltz (2015) show the dangers of a regulation that neglects liquidity risks stemming from potential sovereign stress. Banks widely use sovereign bonds as

collateral in repurchase transactions and a negative shock from distressed government debt will propagate through this collateral channel and the run-off of bank liquidity may translate in system-wide liquidity stress. They therefore propose to raise the liquidity coverage ratio with an add-on for the actual liquidity risk of the sovereign assets that banks use for securing their repurchase transactions.

#### *Net stable funding ratio*

Another new element of Basel III introduced in EU banking legislation is the requirement for credit institutions (and systemic investment firms) to maintain a stable funding profile in relation to the composition and maturity of their assets and off-balance sheet activities. The objective is to reduce the longer-term funding risk of banks, i.e. the likelihood that disruptions in regular funding sources could endanger their liquidity position, which in turn could undermine their solvency and cause broader systemic stress. Following a reporting and observation period, during which a credit institution's long-term assets had to be covered with a diversity of stable funding instruments, the so-called net stable funding ratio was expected to become a binding minimum standard by 1 January 2018. The details of the net stable funding ratio were however only laid down by the Basel Committee on Banking Supervision in October 2014 (BCBS, 2014). Following an EBA recommendation, the European Commission (2016) proposes to take them over in EU banking law with some amendments, with full application of the net stable funding requirement expected to be two years after the new regulation enters into force – which could be mid-2019 at the earliest.

The BCBS defines the net stable funding ratio – which should always be equal to at least 100% – as the available amount of stable funding relative to the required amount of stable funding over a one-year period. Both amounts are calibrated reflecting the stability of a bank's liabilities and the liquidity of its assets. An important assumption is that unencumbered high-quality and liquid assets that can be securitised or traded can easily be used as collateral to secure additional funding or sold in the market and, therefore, do not need to be fully financed with stable funding. Claims on or guaranteed by sovereigns are regarded as extremely high-quality and liquid assets (level 1), in line with the liquidity coverage ratio (see above), and therefore receive a preferential treatment. The BCBS agreed that only 5% of their value needs to be covered by stable funding, irrespective of the actual credit quality and market liquidity of these assets. The European Commission (2016) proposal reduces this stable funding factor to 0% for central government bonds with level 1 status in the EU liquidity coverage ratio, so as to avoid negative impacts on the liquidity of

national sovereign bond markets in the specific European context. This makes it even more attractive for banks to buy and hold sovereign bonds, as these assets make it easier for them to meet the net stable funding ratio than when they would invest in private securities.

### *Large exposures regime*

The large exposures regime in EU banking legislation focuses on avoiding concentration risk arising from large asset holdings, i.e. the risk that losses vis-à-vis a given counterparty or in particular instruments could become so large as to threaten a bank's solvency (see Castro and Mencía, 2014). To ensure adequate diversification across counterparties and assets, EU credit institutions and investment firms must keep their large exposures below the maximum of 25% of eligible capital.<sup>7</sup> This contrasts with the preferential treatment for sovereigns. As claims on the government (or claims carrying their guarantee) are perceived to be risk-free and liquid, as before, credit institutions do not face a maximum on their sovereign exposures (Gros, 2013; Weidmann, 2013). Still, the new EU banking rules do ask banks to put in place effective internal controls that address concentration risks, including those arising from large sovereign exposures.

### *Leverage ratio*

An important new regulatory tool put forward in the Basel III framework is the 3% minimum leverage ratio (in terms of tier 1 capital relative to gross total asset exposure including off-balance sheet positions), which restricts the build-up of excessive leverage in the banking sector and supplements the risk-based capital requirements with a non-risk based 'backstop' measure. EU banking legislation also introduced the minimum leverage ratio as a new prudential tool in Europe. This entailed a mandatory reporting of the leverage ratio by credit institutions as of January 2014, allowing a qualitative assessment to be made by national supervisors. This was followed by a public disclosure as of January 2015. After further review and calibration the European Commission (2016) proposes to follow the Basel III leverage ratio requirement of 3% and to make it binding two years after the new regulation enters into force, which as mentioned above could be mid-2019 at the earliest.

A leverage ratio that simply relates a bank's core capital to its non-risk weighted assets has the potential to counter the many uncertainties surrounding a risk-based system of capital requirements and, therefore, also the preferential treatment of claims on the government

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<sup>7</sup> To make the large exposures regime more risk sensitive, the European Commission (2016) proposes to limit the eligible capital to tier 1, thus excluding tier 2 capital. In addition, it introduces a lower limit of 15% for large exposures of one global systemically important bank to another.

compared to those on corporations. A bank's sovereign exposures will be fully included in the assets entering the calculation of the leverage ratio, although in the EU context some specialised credit institutions can make particular adjustments. Public development banks may exclude their claims on regional governments, local authorities or public sector entities when these serve to finance public investments. Similarly, banks may exclude exposures arising from passing-through promotional loans and officially guaranteed export credits from the calculation base. Some credit institutions may have to adjust their portfolios in order to comply with the 3% minimum leverage ratio, in which case changes in public and private sector exposures will generally count the same and do not give rise to a funding privilege for governments (ESRB, 2015).

### *Reducing the preferential treatment of sovereign exposures for banks*

Looking ahead, several experts have advised European authorities to reduce or eliminate the preferential treatment of sovereign exposures in EU prudential banking legislation, as part of an international agreement<sup>8</sup> (see among others IMF, 2012; Nouy, 2012; OECD, 2014; Deutsche Bundesbank, 2015; ESRB, 2015; BIS, 2016). The main objectives would be to better align the regulatory treatment of credit risk and interest rate risk, remove regulatory distortions among asset classes, discourage large bank exposures to their own sovereign and improve the incentives for sound fiscal policies. For example, one could phase in requirements that banks apply realistic risk weights to their holdings of government debt, use more cautious liquidity assumptions, hold more stable funding, and/or put a limit on the size of their domestic government bond portfolios or on their overall exposure to European governments. As emphasised by Angelini et al. (2014), Castro and Mencía (2014), ESRB (2015), Lanotte et al. (2016), Lenarčič (2016) and BIS (2016), implementing these regulatory solutions raises several conceptual and practical questions.

First, appropriate variable risk weights for sovereigns make bank balance sheets more immune to fiscal stress but are likely to generate pro-cyclical effects on the economy. Credit risk tends to rise in a downturn. This raises the amount of capital that banks would need to set aside for its sovereign bond holdings or it triggers sales in volatile bond markets and makes government funding more expensive, thereby limiting a country's fiscal space to support the

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<sup>8</sup> Corresponding discussions at the European level and in the Basel Committee on Banking Supervision have started. To preserve a 'level playing field' for its banking sector it appears that Europe would rather wait for an international agreement in Basel than decide to go ahead with changing the prudential rules for sovereign exposures on its own.

economy. This could actually increase the incentive for governments to apply alternative financial repression solutions.

Second, binding limits on government debt exposure could constrain banks in playing a role as contrarian investors in securities issued by their own country. In the wake of the euro area crisis many European banks (and other financial institutions) have substantially increased their holdings of domestic government debt. While this growing sovereign exposure increased the risky nexus between banks and their governments, their purchases helped to stabilise national sovereign bond markets at a time when foreign investors retreated from crisis-hit countries. A reduced ability of banks to play this market-supporting role could imply a greater likelihood that distressed euro area countries have to request funding from the European Stability Mechanism (ESM) or that the ECB has to intervene in dysfunctional sovereign bond markets.

Third, new rules imposing higher bank capital and liquidity buffers for sovereign risk and/or a maximum on sovereign exposures may impair the functioning of financial markets. While sovereign and corporate bonds would be treated on a more equal prudential footing and the banking sector would be better protected against the impact from fiscal stress, the higher capital and liquidity charges could hurt bank profits in the short run, reduce bank lending and harm the economy. Following a limit on sovereign exposures many banks also have to downsize their current government bond holdings. The question is whether non-banks are able to absorb this portfolio shift without disrupting price formation in capital markets. Government bonds also play a key role as collateral in repurchase transactions. Restricting the size of bank holdings of sovereign debt securities may therefore lead primary dealers and market-making banks to reduce their arbitrage activities. This would reduce bond market liquidity and weaken the transmission of monetary policy further along the yield curve unless non-banks step in to fill the void.

Finally, the question comes up how to measure sovereign risk. Since the focus of the G20 has been on avoiding an undue reliance in financial regulation on the assessment by credit rating agencies and the ‘cliff effect’ associated with rating changes, alternative risk metrics must be found. Gros (2013) suggests assessing a government’s creditworthiness on the basis of its public deficit and debt figures and compliance with the excessive deficit procedure of the Stability and Growth Pact. Similarly, Lanotte et al. (2016) propose developing quantitative indicators of fiscal sustainability to assess sovereign credit risk.

Given the special role of sovereign debt as ‘safe’ asset in the financial system and the pervasive impact of the existing preferential regulatory treatment of government bonds on both sovereign debtors and creditors any limitation should be carefully calibrated and allow for a (long) transition regime – although financial markets are likely to frontload expected regulatory changes. Going beyond changing the EU legislative framework supervisors could also push banks to contain the risks associated with sovereign exposures, basing their assessments on stress tests and a range of risk metrics. In addition, they could impose more detailed disclosure requirements with regard to banks’ sovereign exposures.

The preferential treatment of sovereign exposures and governments’ market access is moreover found in a growing body of EU financial law (see further below). Any regulatory attempt to reduce it would have to be coordinated at the international level, take account of the financial structure to avoid regulatory arbitrage and allow for a (long) period of transition to avoid market disruption.

### *3.2 EU banking structure regulation*

The favourable regulatory treatment of sovereign debt can also be found in the proposed EU banking structure regulation that addresses concerns about large banks being “too-big-to-fail, too-big-to-save and too-complex-to-resolve”, especially at the national level (European Commission, 2014a). Given the threat that systemic banks pose to the stability of the financial system and the implicit subsidy they enjoy from a potential bail-out by the public sector in times of banking stress it is considered important to improve the resilience of important credit institutions and, if necessary, to break them up (see also ESRB, 2014).

The European Commission (2014a) proposal of January 2014 therefore contains two key elements. First, it would prohibit major EU banks from carrying out proprietary trading in financial instruments and commodities, i.e. taking speculative positions for making a profit for their own account, with effect from January 2017. Second, if there is a risk of circumvention of this prohibition, it would give the national competent authority the power (or even the obligation) to require from major EU banks that they separate all high-risk investment activities that are not related to their traditional retail financing of the economy and place them in a distinct trading entity. This provision would become effective from July 2018. The European Commission (2014a, p.2) believes this “will curtail the artificial expansion of banks’ balance sheets, particularly those activities of a purely speculative

nature, thereby reducing the risk that taxpayers have to step in to save failing banks, and reducing the cost and complexity of any resolution when required”.

A notable feature of the Commission proposal is that it exempts the buying and selling of financial instruments issued by Member States from the ban on proprietary trading and from a possible separation of risky trading activities. This exemption is explicitly made consistent with the zero-risk treatment of bonds issued by central and regional governments (as well as the EU and other entities) under the EU banking legislation (as discussed above), in order to avoid disturbing sovereign debt markets. Again, investments in government bonds are assumed not to pose any credit risk to major banks and accordingly they are unrestricted in taking significant speculative trading positions in sovereign financial instruments, even in those which in the end might harm their balance sheet. While the envisaged structural reform of the EU banking sector would reduce the implicit public sector subsidy to large banks, it would extend the privileged treatment of government debt.

The ongoing discussion of the Commission proposal in the EU Council and the European Parliament indicates support for including a clause in the regulation that would mandate a review of the exemption given to trading in government bonds so as to take account of possible new views on the treatment of sovereign risk at the European and international level.

### *3.3 EU regulation on money market funds*

Following the heavier regulation of banks, the European Commission also set out to address the risks of regulatory arbitrage arising when certain banking activities could migrate towards the comparatively less regulated shadow banking system, including money market funds. Concerns focused in particular on the possible accumulation of liquidity and stability risks in money market funds that engage in bank-like activities, offer a return to investors in line with money market rates, represent a key source of short-term financing for the economy and are of systemic importance in the asset management sector.

Following an invitation by the European Parliament to address these specific risks, the European Commission (2013d) put forward a proposal in September 2013 for an EU regulation on money market funds. The main objective is to introduce common standards across the Member States that increase the ability of money market funds to withstand redemption pressures in stressed market conditions and thereby protect investors, safeguard financial stability and preserve the integrity of the EU internal market. The common rules should ensure inter alia that money market funds only invest in eligible liquid assets, these

are of high credit quality, well diversified and subject to concentration limits, and that those money market funds promising their investors a constant net asset value (CNAV) hold a cash buffer of 3% of their assets to absorb market movements.

The draft EU regulation on money market funds includes several provisions that create privileges for government debt financing. This first relates to the eligible assets in which money market funds are allowed to invest. The requirement that money market funds can only invest in specific money market instruments that have one of the two highest internal credit ratings does not apply to those instruments issued or guaranteed by a central authority or central bank of a Member State. This provision is beneficial to central governments that do not enjoy such a high credit standing. Furthermore, money market funds are explicitly allowed as part of a reverse repurchase agreement to receive non-eligible liquid transferable securities or money market instruments, provided these are of high credit quality and issued or guaranteed by a central authority or central bank of a Member State or of a third country. Again, central governments that do not have such a high credit standing receive a preferential treatment.

Second, the provisions on the investment policies of money market funds contain derogations for sovereign debt, both with regard to the diversification requirements to contain the exposure of money market funds to counterparty risk, and the concentration limits to prevent that a money market fund becomes excessively important for a single issuing body. A competent authority may under certain conditions allow a money market fund to invest up to 100% of its assets in different money market instruments issued or guaranteed by a central, regional or local authority or central bank of a Member State or the central authority or central bank of a third country. Similarly, no concentration limit applies in respect of the holdings of money market instruments issued or guaranteed by these sovereign entities. In short, the draft EU regulation creates considerable leeway for national competent authorities when assessing the mutual exposure between money market funds and sovereign entities issuing money market instruments.

Third, those CNAV money market funds that concentrate their investments in debt issued or guaranteed by the Member States might in future be exempted from the requirement to build up a cash buffer against market volatility. The draft EU regulation mandates the Commission to evaluate the functioning of the market of sovereign-related debt in relation to the operation of the cash buffer during the first three years after this EU regulation has entered into force. Taking into account regulatory developments at the international level (that might seek to

change the preferential treatment of sovereign risk), it should consider the possibility of creating a special legal framework for money market funds with portfolios concentrated in government-linked debt. This provision is motivated by the specific liquidity and credit quality characteristics of these assets as well as the vital role that money market funds play in the short-term financing of the Member States. At the same time, it can be read as an attempt to secure a privileged access of governments to money market funds.

Although the EU Council agreed to a stronger prudential oversight of money market funds in mid-2016, the draft EU regulation is still subject to agreement with the European Parliament and the date when it is supposed to enter into force was left open.

#### **4. The preferential treatment of government debt in EU investment law**

##### *4.1 EU investment funds directive*

As regards other financial institutions than credit institutions, investment firms and money market funds, the EU legal provisions relating to undertakings for collective investment in transferable securities (UCITS) must be considered. As noted by Kopf (2011), the EU investment funds directive – the first version of which (UCITS I) dates from December 1985 – restricts the investment policies of collective investment funds, but offers ample scope for national regulators to exempt government debt from standard exposure limits that apply to private sector instruments.

Already since UCITS I, collective investment funds may place up to a maximum of 35% of their net assets (in terms of transferable securities or money market instruments) in instruments issued or guaranteed by a single Member State, its local authorities, a third country, or a public international body to which one or more of the Member States belong. By way of derogation, they can even invest “in accordance with the principle of risk-spreading” up to 100% of their assets in different transferable instruments issued or guaranteed by one of these government bodies, provided that this is mentioned in the fund rules, unit-holders have equivalent protection and securities from any single issue account for less than 30% of total assets.

This legal provision compares with a standard counterparty exposure limit of 5% for this type of assets when they are issued by the same private sector entity (or by entities belonging to the same group). This ceiling may be raised to 10% under the condition that the total value of all such assets exposed to the same entity stays within 40% of the value of all the investment fund’s assets. UCITS III introduced as from February 2002 the possibility for national

regulators to raise the standard 5% exposure limit to 25% for covered bonds issued by a credit institution that invests the proceeds in assets with a high capability to cover the claims on these bonds on a priority basis in case of their default. The total value of such counterparty exposures was in this case restricted to 80% of the value of all the investment fund's assets. This latter addition reduced somewhat the regulatory privilege that the UCITS directive bestows on sovereign issuers relative to banks issuing covered bonds.

Allowing for very large collective investments in assets related to a single government appears to go beyond prudent concentration limits and the principle of risk diversification. This government funding privilege can nevertheless also be found in the latest edition of the EU investment funds directive (UCITS IV), which entered into force in December 2009 and took effect from July 2011 (European Union, 2009a).

#### *4.2 EU prudential legislation for insurance undertakings*

European institutional investors tend to have long-dated liabilities on their balance sheets which they seek to cover with long-term assets. Low-risk government bonds with long maturities are therefore an attractive instrument for these 'buy and hold' investors. This is one reason why the successive EU directives for insurance undertakings contain a preferential treatment of sovereign exposures, in particular by allowing national regulators to exempt claims on the government from standard exposure limits that apply to claims on the private sector (in a way similar to the UCITS directive).

Just as for banks, the effective scope of this government funding privilege broadened substantially with the introduction of the euro in 1999. According to the prevailing prudential rules, European institutional investors had to match the currency of their assets and liabilities. As exchange rate risk disappeared, those domiciled in the eurozone could suddenly expand their domestic government bond portfolios to sovereign issuers from the whole monetary union.

The EU directive for insurance undertakings known as Solvency I became law in end-2002 and confirmed this currency matching based on the euro. While it did not set capital requirements, it gave Member States the freedom to introduce their own risk-based frameworks in national legislation. The main sovereign privilege remained that investments in central, regional and local government debt could be exempted from asset diversification requirements. Nouy (2012, p.98) observes that this exemption could be interpreted as an encouragement to hold government debt. At the same time, she notes that insurers were not

(or not anymore) constrained by law to invest in (domestic) government bonds, because this would amount to financial repression.

Under the new EU insurance and reinsurance directive, Solvency II, insurance companies are required to value both their assets and liabilities consistent with market prices and to hold adequate capital against an array of risks related to their investments, the so-called Solvency Capital Requirement (SCR) (see European Union, 2009b). While the Solvency II directive was already proposed by the Commission in July 2007 and entered into force in end-2009, its application was postponed (twice) from January 2013 to January 2016 to take account of the new European supervisory architecture, in particular, the establishment of the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) as of January 2011. A new, complementary EU directive was needed to further detail the powers of EIOPA and ESMA (European Union, 2014).

During this legislative process, the European Parliament (2012) argued that, given the sovereign debt crisis, “a zero-risk treatment for government bonds no longer corresponds with economic reality”. Therefore, it called in this respect for a more risk-sensitive calculation of the own funds that insurers would be required to hold as a buffer against sovereign exposures, although it cautioned that account should be taken of potentially destabilising effects in periods of market stress.

The Solvency II directive specifies that the SCR may be calibrated using the standard formula as specified in the legislation, or an internal model approved by the national supervisory authority (for details see European Union, 2015b). Under the standard formula, Solvency II requires insurers to hold adequate capital to cover for interest rate risk and currency risk associated with their sovereign bond holdings. By contrast, claims on EU central governments issued in their own currency enjoy a capital exemption with regard to the market-risk related sub-modules for concentration risk (stemming either from lack of diversification in the assets portfolio, or from large exposure to default risk by a single issuer of securities or a group of related issuers) and for spread risk (i.e. the sensitivity to changes in level or volatility of credit spreads over the risk-free interest rate term structure).

Solvency II further includes a similar transitional approach as the new EU banking legislation: until 2017 a capital exemption also applies for concentration risk and spread risk related to those EU sovereign exposures that are denominated and funded in any other EU currency than that of the issuing country, while afterwards this preferential treatment is

phased out. As from 2020 in these cases the standard model's computation based on credit quality must be applied. Given the fact that euro area countries share the same currency, insurance companies in the eurozone can by default apply a zero capital charge for concentration risk and spread risk related to all EMU sovereign exposures denominated and funded in the euro.

Many larger insurance groups are instead applying their internal models to compute the SCR and therefore have to make more accurate assumptions regarding the sovereign risks in their portfolio and ensure an appropriate amount of capital to cover for them. Still, as noted by the ESRB (2015), they might receive approval from their national supervisors to use the same preferential assumptions for EU sovereign exposures as in the standard formula in order to maintain a level playing field among insurers. Comparing the biased assumptions under the standard formula with more realistic partial internal model calculations of sovereign credit risks, Gatzert and Martin (2012) conclude that the degree of underestimation of the SCR depends on the credit quality of the government bonds and is especially severe for lower-rated sovereigns.

Höring (2013) conducts a review of the literature on the impact of Solvency II on the investment portfolios of insurance companies. He finds many studies expecting a reallocation to less capital-intensive assets and a greater appetite for EU sovereign bonds issued in domestic currency, in particular lower-rated government debt. Düll et al. (2015) confirm this anticipated response and document a bias towards investing in domestic government bonds for 17 large European insurance companies based on data for the period 2009:Q4 to 2013:Q1. They further show that market expectations of the default risk of insurance companies are positively correlated with the riskiness of their sovereign bond portfolios. This finding would justify introducing a capital buffer against sovereign exposure to absorb potential losses.

Solvency II also enhances governance and risk management and explicitly asks insurance companies to conduct an adequate own risk and solvency assessment, even in those cases where the standard formula for the calculation of credit risk allows them to consider EU government bonds as risk-free. This assessment acquires special importance, since all assets including sovereign bonds are to be valued at market prices and insurers are therefore well-advised to account for the credit risk of their counterparties, also those related to governments.

### *4.3 EU prudential legislation for occupational pension funds*

A European prudential legislative framework for occupational pension funds was established in 2003 with the EU directive on the activities and supervision of Institutions for Occupational Retirement Provision (IORP). Member States were given discretion on the precise investment rules that they wanted to impose at the national level: they could be made more stringent, but could also entail a preferential treatment of government debt. Similar to Solvency I, national regulators could decide to exempt investments in government bonds from diversification requirements, thereby offering occupational pension funds the opportunity – if not an incentive – to create a substantial exposure to sovereign risk. However, Member States could not require them to invest in domestic government bonds, whereas this had been quite common in the past.

After the introduction of Solvency II, to ensure a level playing field with insurance undertakings offering pension products, the European Commission (2010b) suggested that also occupational pension funds should hold a sufficient capital buffer. Originally, the Commission planned to extend the preferential treatment of government exposures in Solvency II to the new solvency requirement for occupational pension funds to be introduced in a recast of the IORP directive (IORP II). Following critical comments from stakeholders, however, it decided in May 2013 to defer the introduction of a harmonised solvency rule for occupational pension funds. The IORP II directive that was agreed in mid-2016 instead focuses *inter alia* on improving risk management and enhancing information for pension scheme members.

As shown by Amzallag et al. (2014), imposing a minimum solvency requirement could lead occupational pension funds to rebalance their portfolios in favour of low-risk assets, including government bonds. The authors also report that already the announcement of the possible introduction of a new solvency rule caused some de-risking of pension fund portfolios towards fixed-income instruments.

## **5. The preferential treatment of government debt in EU market law**

### *5.1 EU market infrastructure regulation*

Following a G20 agreement, EU legislation has also been implemented to increase the transparency of over-the-counter (OTC) derivative contracts such as credit default swaps, reduce the uncertainty about the risks involved in derivative transactions, protect against market abuse, and thereby allay the related financial stability concerns. The European Market

Infrastructure Regulation (EMIR) of August 2012 (European Union, 2012b) requires 1) the reporting of all derivative contracts to trade repositories, making them accessible to supervisory authorities; 2) the clearing of all standardised OTC derivative contracts through a central counterparty and liquid, high-quality collateral assets to be posted by the parties to both centrally and non-centrally cleared derivative contracts; and 3) the implementation of stringent organisational, business conduct and prudential rules for the central counterparties.

EU public bodies and central banks charged with intervening in the management of public debt are excluded from the scope of this regulation “in order to avoid limiting their power to perform their tasks of common interest” (European Union, 2012b, p.6). For reasons of international coherence and consistency, the same exemption is being extended to public bodies and central banks outside the EU to the extent that these enjoy a similar treatment in their national legislation (European Commission, 2013c).

EMIR in this respect avoids any interference in the operation of independent central banks using government securities for the conduct of monetary policy in derivative markets. Placing the activities of public debt management offices in sovereign securities markets on one line with those of central banks, because these must be coordinated for efficiency reasons (see European Commission, 2013c, p.12), appears to assume that the two public bodies still are (or should be) closely intertwined. This may reflect the intention to maintain a level playing field with the legal situation for these public bodies in other G20 jurisdictions.

EMIR will lead to more clearing via central counterparties. A central counterparty can only accept highly liquid collateral with minimal credit and market risk to cover the initial and ongoing exposure to its clearing members. The legal provisions and regulatory technical standards specify the types of collateral that could be considered highly liquid, i.e. cash, financial instruments, bank guarantees and gold (see ECB, 2013). For financial instruments to qualify, they should normally be debt instruments issued or explicitly guaranteed by a government, a central bank or a supranational institution.

EMIR also defines a framework for determining valuation haircuts and collateral concentration limits to limit the exposure. Central counterparties are required to establish prudent valuation practices and develop haircuts that are regularly tested and that take into account stressed market conditions. Some of them impose minimum credit rating standards for the acceptance of collateral assets. The concentration limits differ across the various arrangements. For example, they may set a maximum for a certain rating per category of

collateral in the basket, or set a limit on the share of certain issuers (such as regional governments) of the assets in the collateral basket.

As explained by Levels and Capel (2012) and Houben and Slingenberg (2013), EMIR will raise the net demand for high-quality, liquid collateral assets, including sovereign bonds. This may contribute to easing government funding constraints, especially as the additional demand for this type of assets due to EMIR and other EU legislation (as discussed above) is structural and exceeds the growth in supply.

As regards the prudential rules applicable to central counterparties, the European Commission has issued regulatory technical standards to ensure that they are at all times safe and sound and hold sufficient capital against a range of risks (except those risks stemming from clearing activities that are largely covered by specific financial resources). Since these risks are similar to those of credit institutions and investment firms, the capital standards in EU prudential banking legislation serve as the relevant benchmark. For credit risk, the standardised approach must be applied, indicating that the preferential treatment of sovereign exposures in the banking sector (as discussed above) is extended to central counterparties.

## *5.2 EU regulation on credit rating agencies*

Credit rating agencies provide an important service to the market: by rating debt instruments they help to reduce information asymmetries that exist between borrowers and lenders. However, since the financial crisis they have come under severe criticism for having underestimated the credit risks associated with structured financial products. They have also received critical comments for downgrading distressed euro area countries, even after these had just committed to serious policy adjustments that improved their fundamental outlook. Eijffinger (2012) concludes in this respect that rating agencies generally lagged behind markets in their judgement.

Following the financial crisis, three EU regulations affecting the operations of credit rating agencies in Europe have been adopted. Those registered in the EU were first placed under stricter authorisation requirements and new rules of conduct applicable in full from December 2010. A subsequent amendment of the regulation brought them under exclusive supervision by the European Securities and Markets Authority (ESMA) as from July 2011 (European Union, 2011). Further EU legislation in force since June 2013 seeks to reinforce the independence of credit rating agencies, enhance the transparency and quality of credit ratings, reduce the risk of over-reliance on external credit ratings, limit the high degree of

concentration in the rating market, and control the risks associated with the business model of rating agencies. In addition, it introduces a right of redress for investors in and issuers of financial instruments (European Union, 2013a,b). For a legal and economic analysis see de Haan and Amtenbrink (2012).

This new EU legislation also made credit rating agencies subject to specific requirements for sovereign ratings. They have to publish annually at the end of December a calendar for the next 12 months setting two or three dates for issuing unsolicited sovereign ratings and rating outlooks, from which they can only deviate for legal reasons. Sovereign ratings must be accompanied by detailed research reports explaining the assumptions, perceived risks and other key elements on which they are based. While specific national policies may constitute one of these elements, rating agencies are to refrain from giving policy recommendations to a country. Governments are also given more time (a full working day instead of just 12 hours) to react to a change in their credit rating before this is made public, so that they can better verify the underlying data, which must have been taken from generally accessible sources. When a rating agency breaches the obligations, it may be held liable for damages caused intentionally or with gross negligence.

Commission staff also examined the policy option of granting ESMA the power to restrict or ban temporarily the issuance of sovereign debt ratings (see European Commission, 2011b, p.34). This could become relevant, in particular, when exceptional events could trigger contagion and excessive market volatility or when complete information on timing, amount and conditions of an international support programme to stabilise the economy of a troubled country was still missing. The study also considered the option of a permanent prohibition of sovereign credit ratings (see European Commission, 2011b, p.34). For clearly defined exceptional circumstances a temporary suspension was regarded as an acceptable precautionary measure of last resort, although its effectiveness was probably limited. By contrast, a permanent prohibition was in conflict with the fundamental freedom to conduct a business and the principle of proportionality. None of these repressive policy options were in the end seriously considered, as ‘shooting the messenger’ for the bad news on a country’s credit standing was no solution to the underlying fiscal problem.

While there are legitimate concerns with how credit rating agencies operate, the impression is that policy-makers want to ‘punish’ them for unduly downgrading euro area sovereigns. During 2012-2014 the credit rating agencies were in any case more conservative in their credit risk assessment of crisis-affected euro area countries than before the sovereign debt

crisis (de Vries and de Haan, 2016). This greater caution may be due to the stricter EU legislation, the supervision by ESMA, or reflect a deliberate strategy of credit rating agencies to regain their reputation.

Whatever the explanation, a more conservative rating will only have a limited impact on the incentives of policy-makers, as long as market views reflected in sovereign bond yields and credit default swap (CDS) spreads are more favourable than credit ratings. On balance, any government funding advantage resulting from the EU's tightening of oversight of rating agencies and imposing rules for issuing sovereign credit ratings is likely to be moderate. The potential benefits in times of liquidity stress may be partially outweighed by the recent tendency among rating agencies to under-rate the weaker countries participating in EMU compared to their OECD peers.

### *5.3 EU regulation on short-selling and credit default swaps*

Speculators are another typical target in times of market stress. As the financial crisis and sovereign debt crisis intensified, several euro area countries introduced emergency measures to counter excessive speculation by announcing a temporary restriction or ban on short-selling in certain market segments. Short-selling is the practise of investors to sell borrowed securities (including sovereign bonds) with the intention to cover their positions later by repurchasing them at a lower price. This draws concern from regulators, as short-selling is seen to artificially drive prices to lower levels and spur market volatility during a crisis. Also attempts by investors to protect themselves against losses on sovereign debt by purchasing credit default swaps (CDS) are sometimes associated with higher government bond yields. In particular, uncovered (naked) short-selling and buying of sovereign CDS is often seen as contributing to negative price spirals and disorderly markets.<sup>9</sup>

A new EU regulation (European Union, 2012a) harmonised with effect from November 2012 the rules for short-selling and certain aspects of credit default swaps and conferred powers of coordination and intervention on the European Securities and Markets Authority (ESMA).<sup>10</sup> The common regulatory framework gave national competent authorities the possibility to prevent short sales during periods of market stress, introduced a reporting requirement for net short positions above specific thresholds for European shares and sovereign bonds, restricted

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<sup>9</sup> On 8 June 2010, the French President and the German Chancellor sent a joint letter to the President of the European Commission asking the Commission to come forward with a legal proposal to ban naked short-selling and naked sovereign CDS purchases.

<sup>10</sup> The European Court of Justice confirmed in January 2014 that the ESMA has its own discretionary powers to adopt emergency measures on the financial markets of the Member States in order to regulate or prohibit short selling in the pursuit of the EU objective of financial stability.

uncovered short-selling of shares and debt instruments and prohibited uncovered sovereign credit default swap positions in view of their speculative nature. A safeguard clause allows the national competent authorities to suspend the regulation temporarily if the restrictions on sovereign credit default swaps were found to lead to a significant decline in the liquidity of the sovereign debt market. With regard to hedging, market making activities in general and operations of primary dealers in sovereign debt are exempted from the new requirements.

Arguably, uncovered positions pose a danger of settlement failure and market disruption and should be restricted or banned. However, short-selling also supports market efficiency in terms of liquidity, risk allocation and price formation. As argued by the public debt managers of OECD countries (Blommestein, 2010), the ability to manage risk through short-selling operations supports a better functioning of both primary and secondary markets for sovereign instruments. A restriction of uncovered short-selling of government bonds could lead investors to demand a higher risk premium and increase borrowing costs.

Also the new legal requirement that only investors who actually hold EU government bonds (or meaningfully correlated private sector instruments) are allowed to buy protection against sovereign default could reduce market volumes (IMF, 2013). Trades in sovereign credit default swaps will become dependent on investors that are willing to buy the underlying government bonds and wish to hedge against the risk of losses. As a result, more speculative traders would have to turn to unrestricted proxy markets (for example, using futures contracts on sovereign debt or CDS contracts on financial firms that are correlated with a country's credit risk) to place their bets on European sovereigns. This could have the unintended effect of causing dislocations in these other markets and undermining financial stability. A reduced liquidity in the market for sovereign debt protection would moreover raise the costs of hedging and could drive up the costs of sovereign debt issuance.

Overall, this EU regulation may be seen as a constraining or even preventing market participants from expressing a negative view on the creditworthiness of sovereigns, i.e. another example of “messenger shot, message not” (The Economist, 2012, p.64). Already in the run-up to the date of its introduction, the unwinding of net short positions in sovereign debt reportedly contributed to a decline in government bond yields. The longer-term impact of the short-selling restrictions may, however, be a higher cost of government funding (Blommestein, 2010). In addition, the IMF (2013) observed that the phasing out of all uncovered positions in European sovereign credit default swaps coincided with a material decline in spreads and reduced market liquidity, although other factors may also have played

a role. A first review by the ESMA (2013a,b) noticed a slight decrease in Member States' sovereign CDS spreads after the introduction of the prohibition on uncovered sovereign CDS transactions. The liquidity of EU sovereign CDS markets was in general not adversely affected, although CDS markets for specific Eastern European countries experienced a significant deterioration. The CDS indices on groups of EU sovereigns (the purchase of which now requires investors to hold the underlying bonds of all countries in the index) saw a significant decline in liquidity.

#### *5.4 European financial transactions tax*

There have also been many calls by politicians to counter excessive market activity and stabilise financial markets by establishing a tax on financial assets or transactions. In the wake of the financial crisis it is gaining popularity as an instrument to discourage socially unproductive financial transactions, recoup some of the public funds spent on bailing out the banking sector, or to fill bank resolution and deposit insurance funds (IMF, 2010; Botsch, 2012; Burman et al., 2016; Hemmelgarn et al., 2016). Many Member States have already put in place specific taxes on financial operations and/or have recently introduced their own system of bank levies, in particular, to fill bank resolution funds (European Commission, 2013b; Devereux et al., 2015). Given open capital markets, however, their effectiveness will depend on all European financial centres or EMU countries joining in.

Following a request from the European Parliament, the European Commission (2011a) put forward a proposal for an EU-wide tax on financial transactions. The main objectives were to counter excessive market activity, contribute to avoiding future financial crises and ensure that financial institutions (also compared to other sectors) make a fair and substantial contribution to covering the fiscal costs of the crisis. The initiative was also meant to avoid that the single market for financial services gets fragmented by uncoordinated national indirect taxation of financial transactions.

As many Member States were opposed to such a uniform tax, the European Commission (2013a) proposed instead the introduction in January 2014 of a common financial transactions tax in 11 euro area countries (Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia) that had expressed their willingness to go ahead with this tax under the so-called enhanced cooperation procedure (see also Hemmelgarn et al., 2016).<sup>11</sup> The harmonised tax regime would be applied at each stage of a

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<sup>11</sup> France and Italy had introduced their own financial transaction taxes in 2012 and 2013, respectively, while Belgium and Greece already had such a tax in place.

financial transaction and through each financial intermediary, covering secondary-market transactions in shares, bonds and derivatives, while excluding primary market activity. Also transactions undertaken for the purposes of monetary policy, public debt management and some international public policies would be exempted, as well as foreign exchange trading in the spot market (to preserve the free movement of capital) and day-to-day financial transactions of households and firms. Further provisions aimed to avoid tax evasion, distortions and transfers to other jurisdictions.

Some of the participating euro area countries have indicated the wish to exclude trade in government debt securities from the scope of the financial transaction tax.<sup>12</sup> This would, however, create an arbitrary cost advantage for secondary market purchases of public sector debt compared to alternative financial instruments and is a typical example of financial repression to favour governments. As a transitory alternative option, the European Parliament (2013) suggested to limit the tax rate on government bond transactions to only half of the standard rate until 1 January 2017. Additionally, it proposed to apply that reduced tax rate until the same date to all financial trades by pension funds. Other policy-makers have suggested to exempt pension funds altogether from the financial transaction tax in order to avoid that pensioners will get hit by the higher costs of trading (Botsch, 2012). As pension funds typically invest a large part of their reserves in government paper and are regular traders in public sector bonds, this would also be a convenient way for countries to ensure a more liquid government bond market with lower trading costs than for other financial instruments. Advocates of an encompassing financial transaction tax counter that it could nudge asset managers further towards 'productive' longer-term investment strategies and that pensioners would also benefit from the broader effect of more stable financial markets (Gray et al., 2012).

Acknowledging the need for further technical work the participating euro area countries committed in May 2014 to implement the harmonised financial transactions tax in a progressive manner. As a first step, they planned to start with the taxation of shares and some derivatives on 1 January 2016, allowing each further step towards full implementation to take due account of the economic impact. A negative impact on the real economy and on pension schemes was to be minimised. As both public sector and private sector debt securities would not be part of the tax base, the extent of the implied sovereign privilege would be more limited than in the initial proposal. Regarding derivatives, it was agreed that the tax rate

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<sup>12</sup> See European Commission (2013b) for a discussion of alternative options for the scope of this tax.

should be low but based on the widest possible tax base, without impacting the cost of sovereign borrowing. This suggests that derivative contracts for sovereign bonds might be (temporarily) exempted from the tax. By June 2016, politicians could still not agree on the final modalities of the financial transactions tax and its introduction was (again) postponed, to end-2016. Estonia stepped out, as it expected the costs to be higher than the benefits.

## **6. Conclusions**

The overhaul of European financial governance addresses several weaknesses that have come to the fore in the wake of the financial crisis. Some elements in this reform signal a revival of market access privileges for governments, also under cover of prudential considerations.

First, the tightening of EU financial sector regulation and supervision aims to ensure that financial institutions hold adequate capital and liquidity buffers and concentrate on providing long-term lending to the economy rather than engaging in speculative activities. This reflects widespread concerns about the insufficient resilience of financial institutions to adverse shocks, the risks involved in derivative transactions and the state having to bail out ‘too-big-to-fail’ systemic banks. At the same time, most government securities continue to be valued as ‘high quality’ and ‘liquid’ assets carrying zero risk by definition, while they are also exempted from large exposure limits. This preferential treatment of sovereign compared to private debt instruments can be found in a growing number of EU financial laws and fully exploits the opening in the EU Treaty that gives governments a privileged funding access to financial institutions for prudential reasons. EMU countries benefit the most from this privilege, since euro area financial institutions can generally place their funds in the euro-denominated bonds of any eurozone member country without having to weigh the associated credit, liquidity or concentration risks. Many observers have called upon regulators to put an end to these government funding privileges in prudential legislation, or at least to limit them, given moral hazard on the part of sovereigns, financial stability concerns, and the risk of crowding out private creditors.

Second, new EU financial market regulations related to short-selling, credit default swaps and credit rating agencies seek to make the financial system less speculative, less short-termist and less volatile. At the same time, these regulatory measures may be interpreted as aiming to ringfence governments against heightened market pressure. Similarly, the scope of the proposed common financial transactions tax to curb speculative trading might be calibrated to exclude trade in government securities. This would establish a tax-based funding privilege for

the participating euro area countries. The preferential treatment of sovereigns in EU market regulation and taxation could be of particular value in times of high and volatile interest rates, when markets speculate about their solvency, their credit ratings are downgraded, their bonds could face short-selling pressures and investors wish to buy default protection. Yet, it is unlikely to be successful in silencing the market's voice of concern about derailing fiscal positions, especially in the case of debt-ridden euro area countries.

Altogether, the overhaul of European financial governance represents a shift from relatively lenient market rules to more intrusive market regulation. This transition also entails a growing number of government privileges in finance which constrain the effectiveness of capital markets in ensuring fiscal discipline – notably where they help countries with less solid public finances to secure their short-term funding needs and keep interest rates at affordable levels by being able to draw on a more captive investor base. The growing scope of market access privileges for (in particular euro area) governments, as facilitated and legislated at the European level, may be interpreted as the reappearance of financial repression in a modern prudential guise aimed at reducing the burden of high public debt, as a return to the traditional close relationship between the government and the financial industry so as to align mutual interests in fiscal and financial stability, or as a way to increase explicit and implicit taxes on finance and recoup public revenues lost during the financial crisis.

The obvious argument against such a wide and growing array of funding privileges is that it reduces market discipline and creates moral hazard on the part of sovereigns, promoting a bias towards debt-financed public spending and postponing economic reforms, especially for euro area countries. Governments are likely to become complacent, knowing that they are protected from market pressure. Countering these adverse incentives heavily relies on the success of a strict application of the reinforced EU economic governance framework and the effectiveness of peer pressure for ensuring sustainable public finances. Moreover, a regulatory bias towards large sovereign exposures in European financial law may turn into an economic and prudential concern, given the potential crowding out of private funding and the risks for financial stability in times of fiscal stress.

As the discussion in this paper demonstrates, the preferential treatment of sovereign exposures and governments' market access is found in a growing body of EU financial law. Any regulatory attempt to reduce it would therefore have to take account of the financial structure to avoid regulatory arbitrage and necessitate a carefully crafted approach at the global level that allows for a (long) period of transition to avoid market disruption.

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## Annex Table - Preferential treatment of government debt in European financial law

EU financial legislation	Nature of government funding privilege	Market participants affected	Direct benefits to governments	Status 30.11.2016
<b>1. EU banking regulation/directive (CRR/CRD IV)</b> to transpose Basel III		EU banking sector		In force since July 2013; phased in 2014-2019
a) Capital adequacy requirements	EU sovereigns in domestic currency risk free, but phased out for non-domestic EU currencies Temporary capital buffer against sovereign risk		Privileged access to banks	Applies since Basel II; phased out 2018-2020
EBA capital exercise			Offsets privileged access to banks	Applied Dec 2011-Dec 2014
b) Liquidity coverage ratio/diversification rule	EU sovereigns highest liquidity and credit quality		Privileged access to banks	Phased in 2015-2018
c) Net stable funding ratio	EU sovereigns highest liquidity and credit quality		Privileged access to banks	May fully apply in mid-2019
d) Large exposures regime	Exempts EU sovereign bonds, but sovereign concentration risk a bank issue		Privileged access to banks, counters privileged access to banks	Applies since CRD, based on CRD IV
e) Leverage ratio	Focus on total non-risk weighted assets		Counters privileged access to banks	May fully apply in mid-2019
<b>2. EU banking structure regulation</b>		EU too-big-to-fail banking sector		COM (2014) proposal
a) Ban on proprietary trading	Exempts EU government securities		Privileged access to banks	
b) Separation of high-risk investment activities	Exempts EU government securities		Privileged access to banks	
<b>3. EU regulation on money market funds</b>		EU money market funds		COM (2013) proposal
a) Restriction to highest quality eligible assets	Exempts sovereign money market instruments		Privileged access to money market funds	
b) Portfolio diversification rules	Exempts sovereign money market instruments		Privileged access to money market funds	
c) Portfolio concentration limits	Exempts sovereign money market instruments		Privileged access to money market funds	
d) Cash buffer for CNAV money market funds	Possible future exemption of sovereign debt		Privileged access to money market funds	
<b>4. EU investment funds directive (UCITS IV)</b>		EU investment funds		Applies from July 2011
a) Large exposures regime	Allows much higher limits for government bodies, a higher limit also for protected assets from banks		Privileged access to investment funds, reduces extent of govt. privilege	
<b>5. EU directive for insurance undertakings (Solvency II)</b>		EU insurance sector		Solvency I in force; II from 2016
a) Asset diversification requirement	Allows to exempt sovereign bonds		Privileged access to insurers	Applies under Solvency I
b) Capital requirements for market risk	Exemptions for concentration risk and spread risk related to EU sovereigns in domestic currency, but phased out for non-domestic EU currencies		Privileged access to insurers	Applies under Solvency II
c) Own risk and solvency assessment	All assets (incl. sovereign bonds) to be valued at market prices, prudent person principle		Counters privileged access to insurers	phased out 2018-2020 Applies from 2016
<b>6. EU directive for occupational pension funds (IORP II)</b>		EU occupational pension funds		IORP I in force; II deferred
a) Asset diversification requirement	Allows to exempt sovereign bonds		Privileged access to pension funds	Applies under IORP I
b) Capital requirements	As Solvency II		Privileged access to pension funds	Suggestion for IORP II, deferred
<b>7. EU market infrastructure regulation (EMIR)</b>		EU central counterparties/derivative traders		In force since Aug 2012
a) Mandatory central clearing of OTC derivatives	Exemption for official public debt management		Privileged access to derivatives traders	
b) Only high quality liquid collateral	Favours high-quality sovereign bonds		Privileged access to derivatives traders	
c) Capital requirements for central counterparties	Capital exposure to EU sovereigns risk free, but phased out for non-euro area EU sovereigns		Privileged access to central counterparties	
<b>8. EU regulation on credit rating agencies</b>	Affects timing of sovereign ratings	Credit rating agencies operating in EU	Reduced market volatility	In force since June 2013
<b>9. EU regulation on short-selling and CDS contracts</b>	Places restrictions on uncovered short-selling and bans uncovered sovereign CDS positions	Financial market traders in EU	Reduced market volatility	In force since Nov. 2012
<b>10. Common financial transactions tax (FTT)</b>				
a) EU-wide financial transactions tax	Curbs trading in all financial instruments	Financial market traders in EU	EU and national budget revenues	Rejected
b) Common financial transactions tax under enhanced cooperation	Curbs trading in all financial instruments except primary issuance and public debt management	Financial market traders in 11 EA ctrs. (excluding Estonia)	National budget revenues, likely exemption of govt. securities, possible exemption of pension funds	COM (2013) proposal May 2014 political commitment
	1st step: shares and some derivatives			1st step envisaged in end-2016