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Sovereign Risk: Credit Risk Analysis and the Role of PPP Schemes

2.1 Lessons learnt from the financial crisis: the strong link between sovereign risk and bank risk

The financial crisis has brought to light a strong link between sovereign risk, bank risk and corporate risk. Initially, the crisis originated in the banking sector and then spread so quickly it acquired sovereign risk status, especially in majorly indebted countries, such as the periphery countries to the euro zone (Figure 2.1).

As in a chain reaction, no sooner had the crisis flowed from the banking system into financial markets than it instantly affected the real economy. Since then, banks have been registering an unprecedented increase in funding costs and capital absorption due to both the procyclical effects of Basel’s regulations and a non-stop growth of non-performing loans. Falling back on raising capital seemed to be much too dilutive a solution. As a consequence, the main trend was towards “crunching the credit” by restricting lending activities in the real economy, especially by reducing assets in general, or risk-weighted assets in particular. That was like adding fuel to the flames and triggered a downward economic spiral. So far, ensuing business bankruptcies, layoffs and profit decreases have reduced domestic demand and have had a negative impact on tax revenues and national budgets. Just like the banks, heavily indebted economies on the European periphery found it impossible to access financial markets in order to increase their debt. Despite uncertainties, all enterprises were nevertheless directed towards refinancing existing debt.

A link between bank credit risk and sovereign credit risk was established at once. Many banks have since stopped working correctly, thus impeding the normal functioning of transmission mechanisms of monetary policies. The relatively helpful rescue operations actually...
overburdened national budgets and the cost of government bonds reached (and sometimes exceeded) the margins of safety. Immediately, an upswing in government bonds yield spread (measured as the difference between the yield of a government bond and the yield of a bond offering the same duration) caused banks and companies to come to terms with rising financing costs. The European Central Bank (ECB) might have had to face a breakup of the euro zone. In accordance with Basel’s regulations, the ECB decided to rescue the euro by saving the banks in the first instance through a variety of tools aimed at expanding the monetary base. Most importantly, for three years long-term refinancing operations (LTRO) provided the banks with the liquidity necessary (rated at one per cent) to survive independently of the financial markets. As a result, banks in the euro zone periphery were easily able to pay back their obligations and give way to bond buybacks, which should have brought significant capital gains. However, rather than pouring money into the real economy, the high liquidity introduced into the banking system was mainly invested in the acquisition of government bonds, deemed to be not only less risky but also more remunerative than investing in companies. This tendency started a carry trade which did not prevent national economies of the European periphery from defaulting. It also did not help the real economy to recover. How memorable is the ECB president’s pledge to do “whatever it takes” to preserve the euro and price stability.

Current events have been characterized by a strong connection between sovereign rating and bank rating: considerable upswings in the value of bank stocks are directly proportional to downturns in the government bond spread, and vice versa. It follows then that sovereign risk must be analysed and discussed jointly with bank risk (Figure 2.2).