Prof. Dr. Dorothea Schäfer, Research Director Financial Markets at DIW Berlin

EIGHT QUESTIONS TO DOROTHEA SCHÄFER

»New Capital Requirements for EU Government Bonds Would Lead to Problems for Greece«

1. Professor Schäfer, when banks invest in companies by issuing loans, these investments have to be partly financed through equity capital. Bank loans to European governments via the purchase of government bonds are exempt from this regulation. Why is this? For a long time, it was believed that these bond purchases were secure investments because they were backed by governments. The financial crisis, however, has shaken this certainty. The regulation has been in existence for some time already and was not even repealed during the financial crisis. This is because it gave governments easier access to financing.
2. In January 2015, the Basel Committee on Banking Supervision announced plans to review current recommendations on equity capital requirements for government bonds. What exactly is to be changed? In fact, the *Bundesbank* has also been active in this debate on numerous occasions. It believes the same equity capital regulations should apply to EU government bonds as to companies and countries outside the territory of the EU. Depending on the risk, EU government bond purchases would have to be partly financed through equity capital.
3. What are the implications for European banks? Banks would have to show they had sufficient equity capital for the many government bonds on their books. Since they probably do not have any spare equity, they would have to raise these funds. This is something they could either do on the capital market or they could hope for government assistance. Obviously, placing this additional demand on a government could present difficulties to some countries. We can therefore assume that the equity capital would probably have to be raised on the capital market.
4. How high will the additional capital requirement be? The capital requirement for Germany, France, and also Sweden is relatively manageable. For banks from these countries that have undergone the European Banking Authority stress test, the additional capital is in the low single-digit billions. For Greek banks, however, this is likely to be more difficult since they hold a very large number of Greek government bonds with currently poor ratings.
5. What would a change in the regulatory requirements mean for European governments? At least for those governments of EU countries with a poor rating, it will be harder to access funds from banks. We can assume that banks would purchase fewer government bonds with low ratings if their investments in these bonds had to be partly funded through equity capital. This would have a negative impact on these governments' financing options.
6. This is hardly likely to be welcomed by policy-makers. How feasible is a reform such as this? Policy-makers will not be happy and neither will the banks. The *Bundesbank* is a strong proponent of a reform of this type. However, it is likely to be confronted with strong political opposition. It therefore remains to be seen whether it will actually be possible to push through this reform.
7. So what are the advantages? The advantages are that banks would have to prove they had more equity capital which would give them a slightly bigger risk buffer. The additional equity requirement for German, French, and also Swedish banks would be relatively low, though, which essentially means that banks in these north European countries would have marginally larger capital basis. Their equity capital to total assets ratios, however, would not be much better.
8. How will this contribute to stabilizing, or even destabilizing, the euro area? We would not expect it to have a destabilizing effect. However, if the aim is to ensure banks have a higher equity capital buffer, this is not the right strategy. Not only would it have very little impact on most of the major banks, it is unlikely to substantially improve the banks' ratio of equity capital to total assets either.

Interview by Erich Wittenberg.

DIW BERLIN

DIW Berlin — Deutsches Institut
für Wirtschaftsforschung e. V.
Mohrenstraße 58, 10117 Berlin
T +49 30 897 89 -0
F +49 30 897 89 -200

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Translation
HLTW Übersetzungen GbR
team@hltw.de

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Press office
Renate Bogdanovic
Tel. +49-30-89789-249
presse @ diw.de

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