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

INTERVIEW WITH DOROTHEA SCHÄFER

»Capital requirements for new government bond purchases only could be a reasonable strategy«

1. Mrs. Schäfer, the Basel Committee on Banking Supervision has been negotiating the Basel III reform package since 2013. Banks have long been able to finance EU government bonds with 100% third-party debt capital. Is there agreement with regard to increasing the capital requirement for them? The committee members agree that capital requirements for EU government bonds must be implemented in the future. But the details have not yet been made public.

2. Which scenario did you base your study on? We assumed that in the future, government bonds will have to be backed with equity capital based on the standard approach. This means that government bonds from countries with very good ratings would continue to have capital requirements of zero, that is, risk weights equal to zero. Countries with lower rating levels would receive risk weights higher than zero: for example, 50-percent or 100-percent risk weights are conceivable. Assuming that government bonds will be treated as normal credit exposures based on the standard approach, it is possible to calculate the additional capital banks will need in the future.

3. This means that the share of equity capital required for a government bond is based on the rating of the country in question? Exactly. The three most important rating agencies for sovereign states are: Standard & Poor's, Moody's, and Fitch Ratings. We used the ratings that Fitch publishes to calculate the risk weight for government bonds.

4. How much additional equity capital will the banks in the major euro area states need if the "equity capital privilege" is eliminated? The German banks tested in the 2016 stress test will only need 1.8 billion euros of additional equity capital. That is an extremely small amount and only one percent of their existing equity capital. They should be able to raise that in the market at any time. French banks enjoy a similar situation: although their requirement of around three billion euros is somewhat higher, it should be easy to raise. Italian banks, on the contrary, would have an additional capital requirement of around nine billion euros. It is extremely difficult for Italian banks to raise capital right now and considering that the state's rescue fund for Italian banks only contains 20 billion euros, nine billion euros is a relatively large sum.

5. Would an increase in the capital requirement add to the burden of Europe's crisis-ridden countries? Unfortunately, yes. The reason is that almost all of their banks have major holdings of domestic government bonds. If their own country has a low rating now, these banks will require a comparatively large amount of equity capital. They must raise it in the market—a difficult feat for banks and countries with shaky footing.

6. What is your opinion on raising the capital requirement? Would the measure contribute to greater security in the European banking sector? In general, I welcome higher capital requirements for government bonds—it is simply not good risk management to exclude them from all capital adequacy requirements. However, this would mean that countries might have to step in and provide the additional equity capital from their national budgets if banks are unable to raise the additional capital they need in the market. Due to the high sovereign debt levels in crisis-ridden countries, this would be a problem. They would need more money for their national budgets and would have to raise their debt levels once again. The timing would be unfortunate for those countries at present.

7. How could they escape their dilemma? One solution would be to apply the capital requirement to banks' new investments in government bonds only. That would definitely alleviate the situation.

Interview by Erich Wittenberg

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