

BCBS discussion paper on the regulatory treatment of sovereign exposures

9 March 2018

General remarks

BBVA welcomes the possibility to provide feedback to the Basel Committee's discussion paper on the treatment of sovereign exposures.

We share the BCBS's decision not to implement any change in the regulatory treatment of sovereign exposures. This is an issue that has been open for debate for a long time now and the decision of the Committee brings clarity on the banking regulatory framework. The announcement is timely considering the approval of the wider finalisation of Basel III package. The lack of consensus at the global level reflects the difficulty and the challenges that this discussion always poses.

It is often argued that the prudential treatment is the main driver for banks holdings of sovereign debt. But **sovereign debt serves multiple purposes in bank's balance sheets**: risk management (asset and liability or interest rate risk management), compliance with regulatory requirements, collateral for monetary policy operations and business reasons (banks are main market makers in sovereign debt markets). Also, sovereign debt plays an important role in financial markets and in relation to monetary and fiscal policies.

The main options that have been considered within this review include i) imposing positive risk weights to sovereign exposures and ii) applying the large exposure framework to banks holdings of sovereign exposures. But any change to the current treatment would have significant consequences for financial stability, financial markets and the wider economy. Among others:

- **A revision to the current treatment of sovereign exposures would imply a change of paradigm**, as sovereign debt would no longer be a risk-free asset. Risk-free assets have many uses in financial markets. They are a reliable store of value, act as collateral in repos and derivatives markets, are a key benchmark in financial markets pricing and a key instrument in fulfilling prudential requirements (like the LCR). Eliminating risk-free assets from financial markets would have important consequences that need to be considered in advance.

- **Impact on the availability and price of collateral.** Sovereign debt is the main source of collateral in a world of collateral scarcity. If the price of collateral rises for banks, market efficiency would suffer and the cost of financial intermediation would rise. More worryingly, such a move may create incentives for the creation of other sources of collateral, reproducing some of the problems that were at the origin of the recent global financial crises.
- **In economic recessions, fiscal stimulus increase the amount of sovereign debt.** Conversely, in the good times, when there is ample private sector credit, banks have fewer incentives for purchasing public debt. This has a stabilizing effect on fiscal policies, by providing more financing and at better prices in the cyclical downturn, and less financing and at not so attractive prices in the upturn. Eliminating the zero risk weight would eliminate this source of smoothing along the cycle.
- **Inconsistency with other regulatory initiatives.** Any change in the prudential treatment of sovereign exposures would be inconsistent with other regulatory initiatives. In particular with new liquidity requirements. The Liquidity Coverage Ratio (LCR) is not consistent with a large exposure rule or the risk-weight of sovereign exposures. To fulfil this ratio, High Quality Liquid Assets (HQLA) are defined and categorized dependent on their liquidity. Highly rated sovereign bonds are considered top tier liquid assets. The setting of a non-zero risk weight would reduce the base of assets that comply with top tier HQLA requirements, complicating the fulfilment of liquidity ratios, especially in emerging markets where there is little liquid paper apart from government bonds.

Moreover, the imposition of a large exposure limit implies important consequences for global internationally banks. The large exposure limit for sovereign bonds might be lower than the requirements needed to comply with the LCR. Subsidiaries of global internationally banks (especially domestic banks in non-euro area countries) might be forced to hold sovereign bonds from other jurisdictions to fulfil with the LCR ratio and in some cases in currencies in which they do not have any exposure, emerging new risks, such as foreign exchange risk and opening another source of contagion.

After the BCBS decision, preserving a levelled playing field is key now. After the announcement at the global level, any regulatory measures applied at a local level could have extraterritorial negative effects due to the application of prudential regulation at a consolidated level, which would extend the impact of any local measure to a broader scope of banks in different jurisdictions. Therefore, it is important to maintain a holistic a global approach towards the prudential treatment of sovereign exposures.

It is important to take into account the case of global international banks. The application of prudential rules both at an individual and consolidated level can unduly penalise banking groups with presence in third countries. Domestic sovereign exposures held in the subsidiaries can arise through the consolidation process as foreign sovereign exposures, thus being subject to a penalising regulatory treatment. Moreover, this can end up creating an unlevelled playing field for subsidiaries of international banking groups with respect to their local peers.

Specific questions

Q1: Are there any additional sources and channels of sovereign risk in the banking system that are relevant to, and that should be captured in the prudential regulatory treatment of sovereign exposures?

We consider that the first chapter in the discussion paper includes a wide review of the different sources of sovereign risk and the channels through which any sovereign distress can end up affecting other areas of the real economy.

Nevertheless, we should also take into account the stabilizing effects of sovereign debt. Risk-free nature of sovereign debt provides high quality paper in situations of market stress, when there is very limited solvent demand from the private sector. Conversely, in the good times, when there is ample private sector credit, banks have fewer incentives for purchasing public debt. This has a stabilizing effect on fiscal policies, by providing more financing and at better prices in the cyclical downturn, and less financing and at not so attractive prices in the upturn. Eliminating the zero risk weight would eliminate this source of smoothing along the cycle.

Q2: Are there additional roles of sovereign exposures in financial markets and the broader economy that are of relevance to the prudential regulatory treatment of sovereign exposures?

We welcome the analysis on the various reasons for which banks hold sovereign exposures. It is often considered that the main driver for banks' to hold sovereign debt is their regulatory treatment, when actually these instruments serve multiples purposes in bank's balance sheets.

On the one hand, banks hold sovereign debt to manage interest rate risk in the banking book, to manage liquidity risk and comply with the liquidity requirements. The Liquidity Coverage Ratio defines a number of High Quality Liquid Assets (HQLA) dependent on their liquidity. Sovereign bonds are considered top-tier liquid assets in domestic markets. Thus, these instruments are key for the fulfillment of the liquidity requirements.

This is especially relevant in the case of emerging countries, in which the lack of deep, developed markets makes public debt nearly the only available instrument to comply with the LCR. Moreover, sovereign holdings by banks also respond to monetary policy operations, as these bonds are the main source of collateral in financial markets.

On the other hand, sovereign debt also serves business reasons. Banks play an important role in financial markets, acting as intermediaries with clients and also stepping as the counterparty of their clients' trades committing their own balance sheet capacity. Moreover, banks are the main market makers in public debt secondary markets, providing liquidity and depth to these markets. Finally, sovereign debt is the main asset accepted as collateral by central counterparties for financial markets operations.

Q3: What are your views on the potential definition of sovereign exposures?

We welcome the differentiation and separation between sovereigns and central banks. This differentiation, which does not exist currently, is needed whenever any potential measure is being debated in relation to sovereign exposures. Banks' exposures to Central Banks are mainly driven by regulatory requirements, such as minimum reserves requirements or due to the exercise of monetary policy operations. This is particularly the case in emerging markets, where deposits required in central banks are significant.

In relation with the differentiation between sovereign, sub sovereigns and public sector entities we consider that granularity in definition is key. The world of sovereign entities is complex and varies across jurisdictions.

Generally, the sovereigns do not provide explicit guarantees to debt issued by the sub-sovereign entities. Hence, they do not have a legal responsibility to honor debt defaulted by the sub-sovereigns. Their potential support depends more on a "moral obligation" which takes into account subjective factors (e.g. reputation issues). Besides this, in most of the developed countries (and even in some emerging economies) the sub-sovereign sector (typically made up of regions and local authorities) enjoy some (and potentially high depending on the country) degree of financial autonomy.

Moreover, there is major heterogeneity in the sovereign and sub-sovereign sector creditworthiness. In an international perspective, the ratings of sub-sovereign entities differ in most cases from the sovereign ratings, reflecting that despite the control mechanisms issued by the sovereigns there are relatively large (although this depends on the country) differences in the credit profile between the sub-sovereigns (and compared with the sovereign).

Q4: Do you agree that the definition of domestic sovereign exposures should be based on both the currency denomination of the exposure and the currency denomination of the funding? How would such a definition be operationalized in practice?

We agree that the definition of domestic sovereign exposures should be based on both the currency denomination of the exposure and the funding.

However, when defining sovereign exposures as domestic, the case of international active banks should be taken into account. Due to the application of capital requirements at a consolidated level, domestic sovereign exposures held by a subsidiary can appear as foreign sovereign debt for the parent undertaking, even when this exposures are denominated and funded in the local currency of the subsidiary. We need to avoid a distorted treatment for global decentralised banks.

Q5: Do you agree with the potential relative rank ordering of different sovereign entities and with the principle of potential risk equivalence criteria for treating certain non-central government exposures as central government exposures? Do you have any comments on the criteria?

We consider that applying a granular approach that differentiates between sovereign, sub sovereign and public sector entities is coherent with the proposed ranking. Nevertheless, we consider that even if they are treated as different

entities, we need to recognise their special creditworthiness with a treatment that does not differ materially from the one proposed for central governments.

Q6: Do you agree that capital requirements for sovereign exposures cannot be modelled robustly, and that such exposures should be subject to a standardised approach treatment as a result?

Modeling sovereign default could be difficult due to the lack of empirical evidence on actual defaults in advanced economies. But we need to be aware that the standardised approach can also not be a solid measure for sovereign exposures. As a matter of fact, there has been no consensus on how sovereign should be measured and risk-weighted.

We consider that the use of internal models should not be forbidden, and should be retained as an option. There are supervisory tools already available to ensure that internal models can produce robust outcomes for different risk exposures.

Q7: What are your views about how a standardised approach treatment for sovereign exposures should be designed and calibrated? How should such an approach balance simplicity, comparability and risk sensitivity? Are there any holistic considerations which could justify a differentiated treatment across different types of sovereign entities including the relative treatment of central bank and central government exposures?

The differentiation between exposures to the central government and central banks is welcome and necessary. Including exposures to Central banks in any change to the treatment of sovereign exposures would be inconsistent as it would apply to positions that are related to legal requirements or monetary policy operations. For instance, minimum reserves requirements cannot be limited by a large exposure rule, nor should these exposures be risk-weighted when they are mandatory for banks. This problem can be even more relevant in emerging countries, where minimum reserves requirements are normally higher and more variable, to the extent that they are used as a macroprudential tool. A further complication arises from the regulatory treatment of these exposures in a consolidated basis, through which extraterritorial impact from home to host countries can result.

Imposing a positive risk weight to sovereign exposures can have unintended consequences:

First of all, applying a positive risk weight to sovereign exposures would imply a change of paradigm, as sovereign debt would no longer be a risk free asset. Risk free assets have many uses in financial markets. They are a reliable source of value, act as collateral in repos and derivatives markets, are a key benchmark in financial markets pricing and a key instrument in fulfilling prudential requirements. Eliminating risk-free assets from financial markets would have important consequences that need to be considered in advanced.

Moreover, it would be inconsistent with other regulatory requirements, in particular with the new liquidity requirements. To fulfill with the LCR, High Quality Liquid Assets (HQLA) are defined and categorized dependent on their liquidity. Sovereign bonds are considered top tier liquid assets in their domestic markets so the setting of a non-zero risk weight

would reduce the base of assets that comply with top tier HQLA requirements, complicating the fulfillment of the liquidity ratio.

This is especially true in the case of emerging markets, where sovereign debt and certain deposits held on Central Banks are the only instruments with which this liquidity requirements can be met, due to a lack of depth and liquidity in the rest of financial instruments.

Finally, the main question when thinking about a standardised approach is: how do we measure sovereign risk? There is no consensus on this issue because of the great complexity that it poses. On the one hand, credit ratings have certain shortfalls that need to be taken into account. For example, credit ratings tend to be lagging indicators, they are procyclical and the recent financial crisis revealed an over reliance in these indicators for prudential purposes.

The debate on how to measure sovereign risk is related to the discussions on Debt Sustainability Analysis, an area where there is abundant literature, in particular in the IMF, which shows the complexity of a simple measurement. This is related inter alia to the difficulty to distinguish between capacity to pay and willingness to pay in the case of sovereigns, and its link with the capacity to raise taxes or generate other means of financial repression to finance debt (including inflation, low interest rates, compulsory coefficients of public debt and capital controls). All this literature shows the need to avoid simplistic approaches to how to measure sovereign risk.

Furthermore, the proposed look-up table in the discussion paper could benefit from a wider granularity. The current capital framework differentiates 6 credit quality steps, while the proposed table in the discussion paper, only includes 3 quality steps. We consider that more granularity is needed to distinguish between the different credit ratings.

On the other hand, as discussed below, non rating indicators do not seem to capture adequately sovereign risk either.

Q8: What role could specific non-rating indicators play in determining sovereign exposure risk weights in the potential standardised approach?

While rating indicators might have some caveats, the role of potential non-rating indicators should be carefully assessed. Any alternative would face a trade-off between simplicity and accuracy. For instance, the use of a simple ratio such as debt-to-GDP, while transparent in computation, is not a powerful measure of sovereign risk. Empirical evidence shows that some countries had problems at relatively low levels of debt (e.g. Argentina defaulted with nearly 60% debt to GDP), but others have been able to sustain much higher levels of debt without experiencing difficulties (e.g. Japan with over 150% of debt to GDP).

This example illustrates that simplistic solutions should be avoided. The analysis of sovereign debt sustainability (the basis to assess sovereign default risk) is a complex matter. International organisms, such as the International Monetary Fund, have been searching for metrics that successfully encompass all the necessary elements to assess sustainability. The European Union has taken significant advances towards this goal during the financial crisis. However, given that there are not many cases of sovereign default, it is difficult to test the reliability of any potential alternative measure. Nevertheless, it should be clear that relying on simple measures to assess sovereign default would severely understate the complexity of the problem.

Q9: What are your views regarding the potential marginal risk weight add-on approach for mitigating sovereign concentration risk? Do you have any views on the potential design, granularity and calibration of such an approach?

We welcome the decision not to apply a large exposure limit to sovereign exposures, as it could pose significant challenges for financial markets and even financial stability. A hard limit with an obligation to sell all exposures above a certain limit would imply a great amount of sovereign bonds being sold at the same time and could be very disruptive for sovereign debt markets, and with a negative feedback into bank's balance sheets.

Moreover, as it has been stated before, banks hold sovereign exposures in part just to comply with regulatory requirements. Imposing a large exposure limit would be clearly inconsistent with liquidity requirements. Sovereigns are considered top tier high liquid assets in domestic markets, and they are used in a great extent to fulfill this ratio.

Regarding the potential marginal risk weight add-on, we understand that it would work as hybrid option combining a soft limit and potential capital add-ons for exposures above that limit.

As stated before, bank's comply with several regulatory requirements by holdings sovereign debt. This is why any measure regarding sovereign exposures should be adequately calibrated as to ensure that those exposures held to comply with those requirements are not seriously affected by any measure. We consider that the appropriate calibration of an option like this one should be fixed at the Total Capital level, instead of the proposed Tier 1 level.

Moreover, we consider that further granularity would be necessary in a hybrid option. With a large exposure limit involved (even if it is a soft limit), it is important to differentiate between sovereigns, sub sovereigns and public sector entities when defining the potential capital add-on and central banks should always be exempted.

Q10: What are the current market practices related to haircuts for sovereign repo-style transactions? Do you believe that the current repo-style discretion to apply a haircut of zero should be removed from the credit risk mitigation framework?

We consider that the national discretion to apply a lower or even a zero haircut for sovereign repo-style transactions should be maintained. Sovereign debt is the main source of collateral in a world of collateral scarcity. If the price of collateral rises for banks, market efficiency would suffer and the cost of financial intermediation would rise. More worryingly, such a move may create incentives for the creation of high quality collateral, reproducing some of the problems that were at the origin of the recent global financial crisis. Indeed, prior to the recent financial crisis, an increase in the demand of risk-free assets, partly as a result of the regulatory changes that required most institutions to invest in safe assets, stimulated the issuance of significant amounts of private assets through securitisations, especially in the US and the EU markets.

Sovereign bonds are the main source of collateral in financial markets. Currently it is a supervisory discretion to fix a haircut for these bonds to be used as collateral in financial operations. The use of the supervisory discretions is justified by the fact that national authorities are the ones that better know the functioning of their financial systems and the effect of any change on their normal functioning.

This is especially significant in the case of emerging markets, where public debt is not only the main but in some cases the only liquid asset to be used as a collateral in this kind of operations. Applying positive haircuts would mean that banks would need a greater amount of bonds to comply with collateral obligations, and thus it would be inconsistent with any other measure regarding sovereign exposures.

Q11: Do you have any comments of the potential Pillar 2 guidance on sovereign exposures? Is there a need for additional guidance?

Any potential measure applied to sovereign exposures should be equally applied across entities and jurisdictions in order to ensure a level playing field.

Q12: Do you have any comments on the potential Pillar 3 disclosure requirements for sovereign exposures? Is there a need for additional disclosure requirements?

Banks already have disclosure requirements for sovereign exposures under the Pillar 3 framework. We consider that these disclosures are already sufficiently detailed as to provide a good picture of the sovereign portfolio in a banking institution. Moreover, we consider that when defining new disclosure requirements a cost-benefit analysis should be performed so that the new information disclosed is really useful for the different stakeholders.

Q13: Do you agree that home authorities of internationally active banks should be encouraged to recognise the prudential treatment of sovereign exposures applied by host authorities for subsidiaries?

We are of the opinion that any change to the regulatory treatment of sovereign exposures should be agreed at the global level and implemented equally through jurisdictions in order to ensure a levelled playing field between banks and jurisdictions. Under this scenario, there would be no possibility to find discrepancies between the regulation applied at the consolidated level and at the individual level.

Nevertheless, if this was not the case, we consider that host supervisors are the ones that best know the functioning of the financial system in their jurisdiction. Thus, they are the ones that better understand the potential effects that a change to the regulatory treatment of sovereign exposures can pose. That is why in this case we consider that the host treatment should be respected at the consolidated level.

It is important to take into account the case of global international banks. The application of prudential rules both at an individual and consolidated level can unduly penalised banking groups with presence in third countries. Domestic sovereign exposures held in the subsidiaries can arise through the consolidation process as foreign sovereign exposures, thus being subject to a penalising regulatory treatment. Moreover, this can end up creating an unlevelled playing field for subsidiaries of international banking group with respect to their local peers. Hence we support the recognition of host treatment by home authorities, provided they comply with international standards.

Q14: Are there any further revisions to the regulatory treatment of sovereign exposures needed?

No, we welcome the discussion paper and the opportunity to provide feedback. We share the Committee's decision not to apply any measure for the time being.