

Stefan Ingves
Chair, Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
Basel, Switzerland

De Nederlandsche Bank N.V.
Financial stability
Macroprudential Analysis &
Policy

P.O. Box 98
1000 AB Amsterdam
+31 20 524 91 11
www.dnb.nl

Trade register 3300 3396

Re:
Regulatory treatment of sovereign exposures [Discussion Paper]

Dear Stefan,

DNB welcomes the publication of the BCBS discussion paper on the regulatory treatment of sovereign exposures. It is a highly relevant issue that requires further work on the international level. The analysis in the discussion paper provides a comprehensive and holistic overview and makes a welcome contribution towards a more sophisticated and balanced approach of sovereign exposure in the Basel framework.

After the global financial crisis, the Basel framework has been revised. Capital buffers have increased, models have been revised and risk weights have been recalibrated. However, the preferential regulatory treatment of sovereign exposures has not been addressed, although sovereign exposures represent on average 10%-15% of the (unweighted) total assets of banks in advanced economies.

Government bonds fulfil a prominent role in the financial system and in the broader economy. These specifics are well reflected in the report and justify a differentiated treatment of sovereign exposures. However, the current preferential treatment in the framework does not adequately capture actual risks. Losses on sovereign exposures can and do occur, depending on the characteristics of the exposure (denomination, issuing authority, residency of the holding bank). The capital framework should provide for adequate buffers and safeguards to limit the impact of potential unexpected losses from these holdings. Moreover, financial history has taught us that wherever risks are deliberately underpriced, excessive risk-taking typically results.

Sovereign exposures of most banks are biased towards their home country. This interconnectedness between governments and banks can create direct or indirect contagion. In recent years, steps have been taken to reduce the reliance of banks on government support, through a resolution framework and higher loss absorbency requirements. However, as long as governments rely too much on their own banking sector for their funding, the sovereign-bank nexus is not sufficiently addressed.

The negative interaction between sovereigns and banks has been a key factor of the European sovereign debt crisis. An effective and prudential regulation of sovereign exposures would constitute a key element to improve financial stability and is a prerequisite to further strengthen the functioning of the European monetary union and banking union.

Date

7 March 2018

Your reference

Our reference

T046-831188803-231

Handled by

Hengel, M. van (Marco)
m.van.hengel@dnb.nl
+31 20 524 3936

Enclosure(s)

Further steps

DNB encourages the BCBS to continue its analysis on the regulatory treatment of sovereign exposures in the capital framework for banks.

One aspect that needs further consideration is the transmission of sovereign risks under different institutional arrangements (such as, but not limited to, a monetary union). BCBS could deepen our understanding on this aspect through an analytical paper and by actively organizing seminars or expert meetings with market makers, rating agencies and academics. This would provide further basis within the BCBS towards a refined approach of prudential regulation.

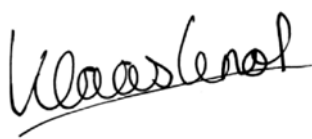
Steps towards a revision of the preferential treatment of sovereign exposures should be carefully designed:

- The prudential treatment of sovereign exposures should be consistent with the methodology of the current Basel framework.
- The design could address both credit risk through the use of positive and more risk-sensitive capital weights as well as concentration risk through mitigating excessive holdings of sovereign exposures.
- Regulation should promote diversification on banks' balance sheets and reduce the interconnectedness between sovereigns and banks. In the euro area, diversification can take place in 19 different national bond markets without incurring foreign exchange risk.
- The relevant set of sovereign risk indicators should be robust and capture potential losses well in advance of the financial cycle.
- A removal of the internal ratings-based approach could only be considered once the current standard approach more adequately reflects sovereign risks.
- The calibration of and transition period for any measure should be considered on the basis of an impact assessment, also taking into account the liquidity framework, and be implemented with an adequate transition period.

Together with this (longer-term) analytical review, the BCBS can take several concrete actions in the upcoming year towards more harmonization and supervisory guidance. We welcome the suggested clarification of the definition of sovereign entities. Furthermore, the BCBS could develop guidelines to what extent stress test outcomes should be taken into account in pillar-2 requirements. Finally, we encourage the BCBS to continue its work towards more transparency, e.g. through enhancing pillar 3 requirements and continued monitoring by the Basel Committee.

We look forward to further work on this relevant topic and would like to continue to contribute to the discussion and any further steps.

De Nederlandsche Bank N.V.



K.H.W. Knot
Governor De Nederlandsche Bank

Date

8 March 2018

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