

SUBJECT: EBF views on the regulatory treatment of Sovereign Risk

The EBF takes note of the BCBS discussion paper on the regulatory treatment of sovereign exposures that has been published together with the terms of the finalisation of the Basel III regime in December 2017.

We would like to contribute to the international debate with a principle-based position. From that angle, we would like to share with policy makers and stakeholders our views on relevant aspects of the subject.

As a general remark, the EBF would like to draw the attention of international standard setters to the wider implications that any proposal on the regulatory treatment of sovereign exposures via micro-prudential supervision may have on the wider economy. Sovereign risk needs to be assessed from the perspective of the whole financial sector and not only for the banking system.

COMMENTS ON THE BCBS DISCUSSION PAPER

On the sources and channels of sovereign risk in the banking system

1. The compilation of past sovereign crises and the overall analysis in the first 2 chapters of the BCBS paper are of the utmost interest and help to approach the issue from a wider perspective and not only from the current economic juncture. It is important to note that the banking sector is now much better equipped to withstand potential future crises, thanks to the regulatory overhaul accomplished in the last 10 years resulting in:
 - a. The capital requirements have significantly increased notably in the form of instruments of the highest quality;
 - b. New short-term liquidity requirements have been introduced;
 - c. A more stable funding regime is being implemented;
 - d. The new resolution regime with the set of bail-inable instruments will (already do) enhance the loss absorbing capacity of banks across the world;
 - e. Resolution plans are widespread in the banking sector.

These factors should be taken into account in the analysis of future crises, their probability and their impact in the banking system.

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2. The policy toolbox for the prevention and treatment of sovereign crises is much wider than the limited scope of the prudential standards. The latter could even have detrimental effects in combination with other measures.

On the holistic role of sovereign exposures

3. We appreciate the approach of the BCBS in this chapter as it sheds light on the determinants of banks' holdings of sovereign exposures. In the opinion of the EBF, there is much misinformation about the reasons why banks hold sovereign exposures allegedly because of the financial crisis. On the one hand, there is the issue of the nexus between government finance and banks; on the other hand, there is a widespread bad publicity about banks' holdings of sovereign exposures that needs to be overcome.
4. The BCBS paper should acknowledge that market making and regulatory compliance are today the main drivers of sovereign investments by banks. Government bond is virtually the only asset class eligible as Highly Quality Liquid Asset (HQLA) for the Liquidity Coverage Ratio (LCR). According to the latest data of the European Banking Authority (EBA)¹, EU banks hold more than double of government bonds than before the crisis. Between 2011 and 2016, banks exposures to HQLA have increased from roughly 1,250 €bn to 2,520 €bn. This multiplication has permitted EU banks to increase the LCR level from the initial 70% to the current 145%.
5. Public sector banks, as well as promotional banks, are set up by central or local governments with the purpose, as laid down in their mandates, to serve public policy objectives. They are inherently linked to the sovereign, therefore public banks and promotional banks should be out of scope of any prudential measures to break the link between sovereign and bank.
6. The BCBS paper fails to consider the links between sovereign exposure and export credit business in corporate finance. In particular, banks in cooperation with Export Credit Agencies (ECA) can transform counterparty risk with sovereign risk. This has knock-on effect on the definition of central government entities (some ECAs sit within the government, others receive government support, others are Multilateral Development Banks). Any distinction on the risk-weight of Local Currency versus Foreign Currency exposures would also disadvantage such export financing in two ways:
 - a. when the exporting guarantee is from a jurisdiction other than the one of the loan's currency; and
 - b. given the dominant role of USD for such export financing, it would *de facto* penalise any guarantee other than from a U.S. ECA.

We also see knock-on effects on any add-ons, as any sovereign deterioration could result in additional capital requirements, although the underlying exposure (the loan) cannot be re-priced to reflect that add-on.

On the regulatory treatment and the potential ideas to change it

7. The standardised approach would introduce cliff effects which, in the case of sovereign exposures, could trigger abrupt market reactions. This would be the situation if the downgrading of a rating agency or the reclassification of a country

¹ EBA report on liquidity measures under Article 509(1) of the CRR, 18 December 2017.

in the OECD criteria trigger a significant increase in the capital requirement. Investors would crowd out thus exacerbating the problem. We do not think it appropriate to use the OECD criteria as its purpose is different from assessing country risk. For example, at the date this note is drafted, one EU Member State, Croatia, is classified in the 4th bucket of the OECD scale for reasons that have no link to the risk of the Croatian sovereign.

8. It is also important to note the procyclicality involved in potential risk-weighted solutions, which could make temporary liquidity crises of sovereign issuers irreversible.
9. The majority of sovereign counterparties do not have an external rating. In some jurisdictions, the potential share of counterparties labelled sovereigns, including regional governments and local authorities, which have external ratings and are active on capital markets is probably a small fraction of the total universe.
10. Another question is how to treat sovereign exposures in foreign currency. We would like to point out that subsidiaries of banking groups in third countries should treat their exposures in local currency according to the local currency rating and this should be the case at consolidated level as well.
11. Jurisdictions with fixed exchange rate regimes in the EU should be able to qualify for treatment similar to domestic currency central government exposures.
12. As regards concentration risk, we think that it is already sufficiently tackled by several prudential measures. In particular:
 - a. Sovereign exposures are included in the leverage ratio which serves as the backstop measure in the scope of micro-prudential requirements.
 - b. The sovereign risk concentration is already monitored in recovery plans and in the Internal Capital Adequacy Assessment Process (ICAAP) of Pillar 2;
13. The minimum level of sovereign risk holdings in a bank is determined by the need to comply with the LCR and the NSFR. Therefore, it would be contradictory and detrimental to the functioning of the banking business to request a cost of capital to those mandatory investments. This is even more the case when the profitability of the banking system is consistently lower than in other sectors due, in part, to the significant increase of capital requirements.
14. The repercussions of the regulatory treatment of sovereign bonds on financial markets also deserve research. In case of an increase in capital requirements of sovereign bonds, banks may be forced to replace the collateral used in derivative transactions with cash and to step out from the repo market with impacts on funding strategies, sovereign debt liquidity and Central Bank monetary policy.