

## **SUBJECT: ABI VIEWS ON THE REGULATORY TREATMENT OF SOVEREIGN RISK**

### **SUMMARY & CONCLUSION**

ABI welcomes the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) discussion paper on the regulatory treatment of sovereign exposures published in December 2017.

ABI also appreciates the possibility to contribute to the international debate with a principle-based position and express its point of view on the regulatory treatment of Sovereign risk issue and its specific observations on some relevant aspects set out in the BCBS discussion paper.

With remarks of a general nature, ABI would like to urge caution against the wider implications that any proposal on the regulatory treatment of sovereign exposures via micro-prudential supervision may have on the broader economy.

In the opinion of the ABI, the sovereign risk issue has to be approached according to a macro-prudential logic, aimed at intervening on systemic risks, rather than micro-prudential measures that tend to reduce the risks of individual banks.

In particular, we are concerned that the proposals in reviewing weighting rules or imposing concentration limits on sovereign risk would damage the growth of the European economy, would still be ineffective with respect to the goal of having a stronger financial system. Moreover, it could/would have negative unintended consequences in terms of the proper functioning of financial markets and on the cost and liquidity of sovereign debt markets.

On the grounds of the above considerations, ABI would therefore recommend shifting the treatment of sovereign exposures to the purview of macro-prudential supervision while maintaining the current prudential treatment of sovereign risk.

### **GENERAL COMMENTS ON THE REGULATORY TREATMENT OF SOVEREIGN EXPOSURES**

**It is true that the crisis has been heightened by the vicious circle between banking and sovereign risk, nevertheless measures taken so far in Europe, although to be completed, have been successful. The effectiveness of these measures is visible, for example, in the dynamics of sovereign risk spreads in Europe. These are indifferentiated measures that do not affect a single economic entity only.**

Since the start of the Euro area sovereign debt crisis in 2010, the attention of regulators and scientific researchers has been focused on the relationship between sovereign and banking risk. The crisis - first financial, then economic and ultimately sovereign - has caused an exceptional increase in CDS premiums on the fixed income securities default risk.

CDS levels have been restored to low record, in line with the reduction in sovereign bond spreads, by a combination of extraordinary monetary policy measures and intervention of reforms of the European Economic and Monetary Union. Extraordinary measures of the ECB include: I) provision of liquidity on demand at fixed rate full allotment; II) facilities to provide medium-term liquidity to banks against collateral in a series of long-term refinancing operations (LTROs); III) targeted longer-term refinancing operations (TLTROs); IV) The Outright Monetary Transactions (OMT) programme; V) the large-scale asset purchase programme (APP); VI) use of negative interest rates. Among the main intervention of reforms of the European Economic and Monetary Union is included the implementation of the Banking Union.

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. An example is the Euro Area crisis that developed during 2011 and 2012. Credit spreads in some countries peaked in 2012 and the solutions put in place brought them down to quasi normal and stable levels one year later without using micro-prudential tools. In fact, the use of micro-prudential measures could potentially have made the problem bigger and more difficult to solve.

**New measures of a different nature, microprudential, are now being proposed. The idea of treating exposure to sovereigns like exposure to private individuals (firms and families) is a fundamental mistake as the micro-prudential approach is ineffective: sovereign risk is a systemic issue, and must be treated accordingly.**

The debate focuses mainly on the following question: for the purposes of safeguarding financial stability, is it fair to treat exposure with sovereign entities differently to exposure with other counterparties (non-financial firms, families, financial companies, etc.) by reserving favorable treatment to them or is it justified to consider sovereign exposure the same as other assets?

The idea that government bonds can no longer be considered "risk-free" – since this theoretical hypothesis is supposedly eliminated with the Euro, having lost the "easy" alternative to default (inflation and devaluation) - leads some to claim that the privileged regime granted to sovereign risk over exposure to private individuals is unjustified. It results in an unfair competitive advantage on the capital market for the public sector compared to the private sector. In some cases, this competitive advantage can cause non-transmission of monetary policy impulses (LTROs) to the real economy, due to the fact that banks choose "carry trade strategies" that are not possible in the case of non-privileged regulatory treatment.

On the basis of the above assumptions, it is therefore argued that zero weighting should be eliminated and exposure to sovereign debt should be treated like exposure with businesses, also imposing concentration limits.

In our view, this reasoning is based on erroneous assumptions and leads to inadequate solutions (micro-prudential rather than macro-prudential interventions).

As far as concerns the proposal to weight sovereign risk, it should be clarified that this approach is based on the assumption that increasing bank capital is a shield that can protect banks from the so-called diabolic loop that could trigger sovereign and

bank risk. Nevertheless, an increase in the capital of the banks to protect them against the country defaulting would be ineffective in practice, regardless of the capital set aside: the bankruptcy of an EU sovereign state would be devastating, not only for the bank that bought the securities of that sovereign state, but for the whole European economy.

The position of those who want to eliminate zero weighting is therefore conceptually wrong. The real underlying mistake is thinking that all the regulations included in the "Basel agreement" tend to reduce risks of individual bank but do not address systemic risks. A change in the perception of the risk of sovereign states in EU countries is a typical case of systemic risk that cannot be countered by micro-prudential measures.

In fact, the positive risk weighting approach introduces a dangerous pro-cyclical element, which could make temporary liquidity crisis of sovereign issuers irreversible, and entails cross border competitive distortions.

Similar reasoning can be extended to the idea of introducing limits on the level of concentration on government bonds. In fact, any exposures limit measures, even if softened with respect to strict hard limits, could trigger unintended systemic implications for the financial and banking system due to the scarcity of safe assets to be used both for Liquidity regulatory requirements and banks' core collateralised transactions (derivatives and repos):

1. implications for Financial Markets: 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 ECB monetary policy. On the other hand, given the limited diversification opportunities in the Eurozone market, EU banks, in order to extend the safe asset to be used for collateral management, could be led to reallocate their sovereign exposures to extra Eurozone Countries increasing their foreign exchange risk;
2. impacts on the cost and liquidity of public debt, due to the possible disposal of domestic excess exposures in the adjustment phase and to the investors' anticipations about market dynamics and their perceived role of banks as single country shock absorber.

**There are many arguments to counter the effectiveness of the new regulatory ideas under discussion and support the maintaining of current sovereign risk treatment. In our view, current proposals under discussion:**

1. ***are worthless in solving the problem*** -

Asking the banks to recapitalize themselves to cover the default risk of the country where their business is concentrated would be ineffective: in that case, banks would still be involved in such and so many private defaults that any additional amount of capital would be worthless in solving the problem. Banks' capital, in fact, regardless of its level, would never be enough to handle a collapse of that nature and size. In fact, risk weights are not an appropriate response to the home bias problem because they are focused on credit risk rather than on concentration risk associated with sovereign exposures. Also concentration charges have substantial drawbacks. With concentration limits in place diversifying the sovereign portfolio would imply for EU banks to reallocate home sovereign exposures to extra Eurozone Countries therefore

increasing their foreign exchange risks (due to the shortage of safe assets in the euro area). Moreover, even if inducing banks to diversify its exposures - introducing limits would not avoid the high correlation within european sovereign yields.

2. *are likely to be detrimental to the growth of the real economy –*

Weighting sovereign exposure to member countries would also be detrimental to the growth of the real economy. This measure would, in fact, be a brake on the dynamics of credit, especially for those banks that have capital ratios close to the minimum regulatory thresholds.

3. *imply risk of a capital outflow outside the EU –*

In addition, the default risk of public securities, especially in an area of monetary integration such as Europe, cannot fail to reflect the domino effect caused by the default of a large state. It follows that a high risk component of a specific country should also be reflected in the weighting of government bonds in other countries closely linked to it, with the consequence that there will be no longer a risk-free reference security in Europe, which would fuel the risk of a capital outflow outside the EU.

4. *are likely to be detrimental for financial market and sovereign debt markets –*

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.

5. *could limit the shock absorber behavior of banks in distressed times –*

It is wrong to claim that carry trade is harmful to the real economy. The opposite is true. During the crisis, bank purchases of government bonds, supported by the liquidity provided by the ECB, worked as a shock absorber minimizing the impact of the crisis for the entire European economy. The purchase of government bonds at the time of the Ltros (carry trade) allowed yields to be reduced and spreads paid on government bonds and, therefore, a reduction in the spread paid by all traders in the economy of the country, as government bonds are the benchmark for pricing all financial instruments within each country. The lower interest expense therefore allowed tax incentive programs to be launched, which would not have been possible if the banks had been forced to increase their capital to buy government bonds or had been subject to limits on their holdings of sovereign bonds.

6. *could determine an unlevel playing field at global level –*

In the event of changes to the current regulatory framework on bank exposure to sovereign risk, it should be guaranteed that the same measure is simultaneously also taken globally, not just in Europe. A heterogeneous inter-continental framework of sovereign risk weighting rules risks fueling speculative processes, with potentially significant effects on public finances and bank accounts, to the disadvantage of Europe compared to other geographical areas. The risk is making the entire European area less competitive in an international context.

## **SPECIFIC COMMENTS ON THE BCBS DISCUSSION PAPER**

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

The detailed account of past sovereign crises and the comprehensive analysis on the sources and channels of sovereign risk in the banking system made in the first 2 chapters of the discussion paper provide the opportunity to approach the issue from different perspectives. However, ABI urges caution in drawing any reliable conclusions from past crises. The post-crisis regulatory reform package (i.e. new capital and short-term liquidity requirements; more stable funding regime, a new set of bail-inable instruments, resolution plans, etc.) accomplished in the last ten years has dramatically changed the prudential landscape.

Against this background, we cannot take into account past crises, their effects or their resolution methods as the reference for crisis prevention in the future.

Moreover, before any changes in the regulatory framework are considered, all the implications will need to be weighed, primarily for national economies and the functioning of capital markets.

### **On the holistic role of sovereign exposures**

Chapter 3 sheds light on the determinants of banks' holdings of sovereign exposures highlighting that they are used by banks for liquidity management, credit risk mitigation, asset pricing, financial intermediation, investment purposes and that they also play an important role as part of monetary policy operationalisation.

In the opinion of the ABI, misinformation about the real determinants of banks' determinants of sovereign debt securities purchases and the widespread bad publicity about banks' holdings of sovereign bonds need to be overcome.

The main drivers of sovereign investments by banks are: the role in market-making they play for such exposures and the legislation and regulatory compliance that provides a more favourable capital treatment for sovereign exposures than for other exposures and that require banks to hold a buffer of liquid assets, which include sovereign debt. Government bond is virtually the only asset class eligible as Highly Quality Liquid Asset (HQLA) for the Liquidity Coverage Ratio (LCR). The European Banking Authority (EBA) recently published the Report on Liquidity Measures Under Article 509(1) of the CRR. According to EBA's data, EU banks hold more than double of government bonds than before the crisis. The data show that the average LCR across banks is 139% and that it has doubled since June 2011. The upward trend in the LCR is driven by an increase in HQLA, which more than doubled between June 2011 and December 2016,

It is important to note that stringent conditions for sovereign exposures could have unintended consequences for the economy, especially when a country is undergoing a weak economic period, because debt issuance may be replaced with harder fiscal policies which may compound the problem of the economic downturn. Therefore, the regulatory treatment of sovereign exposures should be only part of a wider scheme.

## **On the regulatory treatment and the potential ideas to change it**

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 in the OECD criteria trigger a significant increase in the capital requirement. Investors would crowd out thus exacerbating the problem.

ABI is therefore not in favour of an automatic Pillar 1 treatment, whatever its definition and calibration, as a desirable solution for the treatment of sovereign exposures.

Another important issue is the treatment of sovereign exposures in foreign currency. ABI would also like to draw attention to the fact that banking groups' subsidiaries located 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.

As regards concentration risk, we think that it is already adequately covered by the current prudential regime. In particular:

- sovereign exposures are included in the leverage ratio which serves as the backstop measure in the scope of micro-prudential requirements;
- the sovereign risk concentration is already monitored in recovery plans;
- 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.

## **CONCLUSION**

In the opinion of the ABI, the sovereign risk issue has to be approached according to a macro-prudential logic, aimed at intervening on systemic risks, rather than micro-prudential measures that tend to reduce the risks of individual banks.

In particular, reviewing weighting rules or imposing concentration limits on sovereign risk would damage the European economy growth and would still be ineffective with respect to the goal of having a stronger financial system.

On the grounds of the above considerations the ABI would therefore recommend shifting the treatment of sovereign exposures to the macro-prudential supervision while maintaining the current prudential treatment of sovereign risk.