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SISTEMA BANCARIO E FINANZIARIO
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UFFICIO II

Discussion Paper - The regulatory treatment of sovereign exposures. Comments by the Italian Treasury to the Basel Committee.

We thank the Basel Committee for the opportunity to provide our views on the ideas outlined in the discussion paper. The issue is clearly of crucial importance considering the special role that sovereign debt plays in the economy and, as such, deserves a thorough assessment from different perspectives.

High sovereign exposures are seen to increase banks' fragility in case of sovereign tensions; therefore it is generally stated that a more restrictive prudential approach could contribute to mitigate the sovereign-bank nexus, breaking the perverse feedback loop between the sovereign's health and that of the domestic banking system.

We are not sure of this thesis as we believe that banks and sovereigns are inevitably correlated and intertwined, apart from banks' holdings of sovereign bonds. This is fundamentally due to the existence of multiple channels of contagion, as acknowledged in the discussion paper. In fact, in case of sovereign distress, the related macro-economic turmoil depresses the economy, increases the insolvency rate of households and firms, worsening banks' situation. Reducing banks' holdings of government bonds would not, in our perception, avoid this process.

Our concern is, then, that the solution to this issue is unlikely to be provided by a change in the regulatory framework.

On the contrary, historical experience in the Euro area shows that the behavior of banks is countercyclical: they usually reduce their investments in sovereign bonds in normal times, looking for better risk/return combinations, whereas they tend to increase domestic sovereign exposures during periods of sovereign distress, playing an important, stabilizing role. In Italy and Spain, banks and other domestic financial intermediaries increased their sovereign exposures at a time when foreign investors were rapidly fleeing the market. The question is, what could have happened during the euro area crisis had this role been limited by a more restrictive prudential

treatment: our clear perception is that the crisis could possibly have been substantially worsened. This fundamental role of (domestic) financial intermediaries as shock absorbers during a sovereign crisis has therefore to be duly taken into account and, we believe, should not be hampered by specific amendments to the current supervisory framework.

This is why we have substantial concerns with reference to the reform proposals surveyed in the discussion paper: in substance, the financial stability benefits related to a tightening of the prudential treatment of sovereign exposures appear uncertain and possibly overstated, whereas the costs are likely to be significant.

We are unable to support our viewpoint with estimates; the same can be said of the paper, however: the document fails to make a convincing point that the net benefits of a reform would be positive.

Coming to more specific questions asked in the discussion paper, we understand the point that – due to the reduced frequency of sovereign defaults – it is probably difficult to properly model sovereign exposures. It seems to us that it is also difficult to assess sovereign risk within a revised standardized approach, where a new methodology should be defined in order to determine and apply reasonable risk weights. Relying on credit ratings is clearly unwarranted. They have shown their limits and drawbacks, as also acknowledged by the Committee.

A new methodology would likely introduce further complexity, due to the need to develop sufficient granularity in order to be consistent with a risk-sensitive approach.

Significant unintended effects could also emerge from a revision of the large exposures regime. Introducing binding limits on sovereign exposures would force banks to sell sizeable amounts of government bonds without a large buyer on the other side as it now happens with the ECB *asset purchase programme* (APP), that will probably be over by the end of this year. The macro-economic effects of such a scenario are unclear and potentially dangerous; indeed, the Committee itself recognizes that “*there is a case that sovereign exposures should continue to be exempt from the large exposures framework*”.

Also the alternative proposal in the discussion paper to introduce marginal risk weights add-ons to mitigate concentration risk, which would vary based on the amount of a bank’s sovereign exposures relative to its Tier 1 capital, does not appear convincing. First of all, we understand it would come on top of the removal of the current exemption, implying therefore a potential additional overall increase in the capital requirement against sovereign exposures, which would simply amplify the

concerns we have highlighted in the first part of this reply. Secondly, we believe that the practical implementation of this kind of approach would entail significant complexity, particularly with reference to the assessment and calibration of the marginal risk weight add-ons.

In the same vein, we do not believe that the current discretion to apply a haircut of zero for repo-style transactions should be removed from the credit risk mitigation framework: we are particularly concerned by the unintended consequences this might have on the market making activity on sovereign bonds, with related implications in terms of market liquidity (bid-ask spread) which would then turn into a higher cost of funding for sovereigns to be finally borne by taxpayers. Moreover, the repo market is crucial to banks' liquidity management, which would be made more difficult and expensive by the removal of the exemption.

Finally, we are not sure that we need a specific Pillar 2 guidance on sovereign exposures beyond the existing one: this kind of aspect is generally taken into account within the supervisory review and evaluation process, and in stress tests. In the EU-wide 2018 stress test exercise, currently running, the risks arising from sovereign exposures are being covered both in credit and in market risk, depending on their accounting classification.

To conclude:

- any change in the prudential treatment of sovereign exposures could have a significant impact, with the concrete risk to create negative and destabilizing effects in terms of overall financial stability;
- there is no clear and definitive evidence that the potential benefits of a revision of the regulatory framework would outweigh the actual costs.

Considering that supervisory measures have already been implemented since the financial crisis, also aimed at mitigating the sovereign-bank nexus (for example, sovereign debt exposures are considered in the leverage ratio), our strong recommendation is therefore to keep the current prudential treatment for sovereign exposures as it is.