

7 Comments on “Consultation BCBS discussion paper on the regulatory treatment of sovereign exposures”

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The BCBS discussion paper on the regulatory treatment of sovereign exposures addresses a so far hardly touched topic as concerns capital regulation. While the regulatory framework has been changed substantially over recent years including the establishment of the European Banking Union, risk weights on sovereign exposures have remained mostly unchanged and sovereign exposures of banks benefit from a favourable capital treatment. This applies despite the fact that the recent European sovereign debt crisis has revealed the potential of a doom loop between bank and sovereign risk and demonstrated that sovereign exposures are by no means “risk-free”. The paper is thus an important proposal how to change the risk evaluation of banks’ sovereign exposures.

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?

Answer: We believe that the BCBS discussion paper addresses the most important channels and sources of sovereign risk. However, additional risks might stem from the following sources:

The paper discusses several sources of sovereign risk, such as capital withdrawals by external investors, or channels that link sovereign and bank risk, mentioning amongst others sovereign downgrades affecting banks’ ratings. Yet the paper comes a bit short when discussing the role of **international exposures and contagion risk**. For example, there is a literature showing evidence for “wake-up call contagion” implying that risks discovered in one country induce investors to cut back lending to related countries. Similarly, banks are highly integrated and sovereign risk in one country can spill over to other countries via cross-border exposures of banks (Buchholz and Tonzer, 2016).

The role of central banks and monetary policy is discussed from various perspectives. However, central banks have recently introduced large **asset purchase programs** including public sector

purchase programs. The purchase of large amounts of sovereign bonds can affect prices and thus channel back to banks' balance sheet. For example, higher demand for these securities due to the central bank's program can increase prices and thus the collateral value of these assets.

The paper refers to post-crisis reform and the implication of the establishment of resolution mechanisms for sovereigns and banks on the risk transfer between the two sectors. While we agree that risk spillovers via the government support channel can be reduced due to the implementation of resolution schemes, we would like to point out that a **bail-in is just one option** and the Bank Recovery and Resolution Directive (BRRD) still allows for government bailouts of "solvent" banks as has been applied in the case of the Italian bank "Monte dei Paschi". The availability of different options regarding the treatment of banks in distress might generate uncertainty in markets generating risks to financial stability.

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?

Answer: The paper provides a comprehensive discussion about the role of sovereign exposures in financial markets. One point that could be discussed more broadly relates to strategical interactions between banks and states. The authors mention that in "exceptional circumstances, banks may engage in carry trade or "gambling for resurrection" behaviour". However, there is a broad literature discussing political economy aspects of the interactions between banks and their national sovereign. For example, governments might exert pressure on banks to provide funding, see, for example, evidence on such "moral suasion" provided by Ongena et al. (2016) or Ohls (2017). Conversely, banks that are directly owned or indirectly dependent on political representatives might abuse (sub)sovereign debt to endear themselves with newly elected governments in attempts to bridge political distance (Popov and Koetter, 2018). Thus, (sub)sovereign security holdings by government-owned entities may have to be regulated even more strictly – e.g. in terms of large exposure rules and/or haircuts – so as to avoid excessive political entrenchment.

Not only against the backdrop of politically driven sovereign-bank nexus concerns, we also think that a common safe asset within a monetary union would greatly facilitate the smooth and effective transmission of both monetary policy, but also macro-prudential policy in pursuit of financial stability. To us it seems therefore sensible to advance a common E(M)U fixed income instrument more forcefully. Such a financial instrument would, of course, require a common fiscal authority of some kind that is endowed with a robust democratic mandate. On the way towards such a European Fiscal Authority, existing institutions might serve as interim solution to issue such a safe European asset. It is, for example, conceivable to expand the mandate of the European Stability Mechanism in this regard.

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

Answer: We believe that the proposal of straightforward definitions of sovereign exposures is important to lower the degree of (national) discretion and regulatory arbitrage induced by "open-ended" definitions.

A specific point is that sovereign credit exposures by PSEs should generally be accounted for in calculating government exposures. In particular credit amongst and towards large, special purpose vehicles – such as federal, national, and international development banks – should be considered as sovereign rather than interbank exposures so as to avoid an increasing share of "shadow" government debt.

Regarding the criteria for the treatment of subnational units as central government, they appear to allow too much room for discretionary treatment by national governments in our view. Even if counties can levy taxes (Criteria A (i)), they might still be substantially less able to bear debt compared to the central government. A simple and straightforward reason follows from larger exposures to non-diversifiable local shocks. Consider, for example, a region like the Detroit area with a concentrated (car) industry structure that is directly and significantly hit by trade barriers erected by central governments on automobile trade. Such idiosyncratic risks are diversifiable at the level of the nation, but not the region. Hence, subnational debt and credit exposures should generally not be considered equivalent to central government debt.

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 operationalised in practice?

Answer: The idea behind the different treatment of sovereign exposures depending on the currency of the funding seems to be that sovereign exposures denominated in a currency other than that of the sovereign are subject to exchange rate risks. But a differential, specifically a more favourable treatment of sovereign exposures denominated in the domestic currency might foster the home bias of sovereign debt financing. Furthermore, one has to take into account that financial markets offer plenty of options to hedge foreign exchange rate risk.

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

Answer: The relative rank ordering of different sovereign entities seems overall sensible. The criteria for treating non-central government exposures as central government exposures are mostly based on the legislative and constitutional independence of the subnational government. However, we think that already at this stage economic criteria, such as the indebtedness of the non-central government, should be considered more explicitly, too. To us it is not clear, why the approach to treat sub-national securities like sovereign or bank debt, is the most prudent one. For example, in the case of Germany, 37% of German sovereign debt accrued at the subnational level – states, municipalities, and social insurance schemes – in 2013. These entities, in turn, are often legally independent persons that exhibit fairly heterogeneous levels of debt bearing capacity. Therefore, especially credit risk at the subnational level should be (i) assessed in the same way across regulated countries (ii) and follow a standardized approach based on individual ratings of government entities and corporate counterparties (like local utilities etc.) based on tractable estimates of PDs, preferably third-party ratings.

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?

Answer: We support the proposed idea of removing internal based ratings for sovereign exposures. Internal models can be beneficial to calculate risk-weights for specific assets held by a bank. However, due to their importance, most rating agencies provide ratings for sovereign exposures as well as further economic indicators are available, which can be used as guidelines to assign uniform risk weights to be applied by all banks holding these 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?

Answer: We agree with the authors that the standardized approach can be based on external ratings but should be complemented by additional indicators such as CDS spreads of sovereign credit risk/ the country's indebtedness and economic outlook. The proposal that banks should demonstrate that they have assessed appropriately the sovereign's riskiness seems to bring an additional layer of complexity and administrative burden, which should be considered carefully before being introduced. We support the committee's proposal of standardized risk weights as shown in Table 6 compared to a very simplistic or a more granular approach.

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

Answer: See answer above.

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?

Answer: The notion of how to identify a group of connected sovereign counterparties based on the classification of "support" criteria seems very useful for the purpose of defining the unit of analysis in the calculation of large exposures. We also endorse the introduction of a large exposure risk-weight add-on of a non-linear kind. Some specific comments are as follows:

First, to avoid strategic threshold avoidance behaviour, the marginal risk-weights should be allocated continuously rather than according to discrete buckets. It would also make sense to calculate these figures not at one point in time but as (moving) average to avoid spiky reporting.

Second, it is not clear, which "holistic" reasons are relevant enough to avoid any large exposure risk-weight immediately after passing the commonplace threshold of 25% exposure relative to Tier 1 capital. Non-zero risk-weights should in our view disappear right after this threshold.

Third, it is unlikely that sovereign risks are uncorrelated, even if they are classified as separate connected sovereign counterparties according to the criteria in the working paper. Especially during systemic events we have learned that sovereign bond yields start to co-move. Therefore, the total average risk weight on the sovereign exposure should also depend on estimated (tail-risk) correlations.

Fourth, the notion of increasing returns to honour potential "holistic" functions fulfilled by sovereign debt that command a somewhat lower penalty on such relatively small exposures seems sensible to us. However, the increase in the steepness of the marginal weight add-on function is activated at fairly high levels of sovereign exposures as of 250%. We would recommend shifting the flat segment of the curve into the realm 25%-100% weight, but then increasing the steepness much earlier, say for exposures of 150% the latest.

Fifth, it is not clear why there should be a cap for exposures larger than 300%; instead an unbound measure would be preferable.

Q10. What are 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?

Answer: No comment.

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

Answer: The suggestions for Pillar 2 guidance seem quite comprehensive and we do not see the need for additional guidance.

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

Answer: No comment.

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?

Answer: We strongly agree that regulatory treatment of foreign subsidiaries should be recognized by the home authorities. This would help establishing a level playing field with uniform regulatory treatment also for internationally active banks. Differential regulatory treatment of foreign affiliates due to host country plus home country regulation could result in regulatory arbitrage and fragmentation of international banking markets.

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

Answer: No comment.

References

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