

**Comments by Nicolas Véron¹ on the Basel Committee on Banking Supervision's Discussion Paper
"The regulatory treatment of sovereign exposures" (December 2017)**

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The Basel Committee on Banking Supervision (BCBS) is to be commended for having tried to tackle this difficult topic, even though the work performed in 2015-17 did not lead to an agreement. The BCBS also deserves credit for publishing this informative and thought-provoking discussion paper, and thus for signaling that it welcomes continued debate on the issue. This issue is both uniquely difficult and uniquely important. Thus, the lack of agreement so far should not discourage future efforts. The BCBS should envisage next steps, even though there is no specific urgency to do so.

Such next steps should better acknowledge a distinction that is not sufficiently emphasized in the report, between countries in a monetary union (MU) and other jurisdictions. (MUs are assumed here not to include a supranationally integrated fiscal policy framework.) Unlike in other jurisdictions, banks in MU countries can diversify their (national) sovereign exposures without incurring any exchange rate risk. Furthermore, MUs must undertake specific policies to avoid financial fragmentation across their member countries that would impair the functioning of the MU's monetary policy and possibly endanger its integrity. Conversely, other jurisdictions can devalue, an option not available to MU countries individually. If only for these reasons, the optimal regulatory treatment of sovereign exposures is likely to be different in a MU from other jurisdictions that conduct both monetary and fiscal policies.

There is only one MU currently represented in the BCBS, namely the euro area and its Economic and Monetary Union (EMU). As long as this remains the case, and under a principle of subsidiarity, the need for the BCBS to address MU-specific supervisory policy challenges will not be self-evident. Under these circumstances, it seems natural for the BCBS to defer to European discussions on EMU-specific regulatory issues that are not relevant for the BCBS's other jurisdictions.²

This observation applies particularly to the Discussion Paper's section about concentration risk on pages 28-30 (and question Q9). There is a compelling case for the euro area to adopt a pillar-1 instrument akin to the marginal risk-weight add-ons described in the paper.³ But the relevance of such an instrument is much less self-evident for other BCBS jurisdictions, or non-BCBS ones that are not in a MU. This tension is reflected in the indicative calibration in the table on page 29, which would be unduly mild in a euro-area context (as further explained in the paper referred to in footnote 3) but may also be unduly constraining in other jurisdictions, e.g. when it comes to compliance with liquidity ratios.

Two other areas in the report are highly relevant at the global level and deserve further work from the BCBS.

First, standardized definitions of sovereign exposures and more granular disclosures are definitely needed. The BCBS should build upon the tentative proposals covered by the paper's questions Q3,

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² Separately, and as I have written elsewhere, the euro area's representation in the BCBS should be streamlined following the recently implemented pooling of bank supervisory policy at the euro-area level.

³ I have made this argument in a [paper](#) published by the European Parliament in November 2017, referring to marginal risk-weight add-ons as "sovereign concentration charges".

Q4, Q5 and Q12 and aim at a detailed framework for pillar-3 disclosures of sovereign exposures in the medium term. This in turn would open a path for better analysis and further reform. In the European Union, the regular publication by the European Banking Authority since 2011 of country-by-country exposures of most of the largest banks has had a very positive impact, not least by stimulating academic and market research on this issue that did not exist before for lack of publicly available data.

Second, the paper's discussion of sovereign credit risk assessment (related to questions Q6, Q7, Q8, and Q13) highlights the trade-offs of internal ratings-based (IRB) versus standardized approach in the case of sovereign exposures, including the difficulty of defining a suitable standardized approach given the special features of sovereign risk. I am not sure the IRB approach, despite its evident shortcomings, should be dismissed from the outset of that discussion. It would be useful for the BCBS to undertake and publish a detailed study of past and current sovereign-exposure IRB (and SA) practices in various jurisdictions, to allow for a better informed future discussion of this highly contentious issue.