Welcoming remarks

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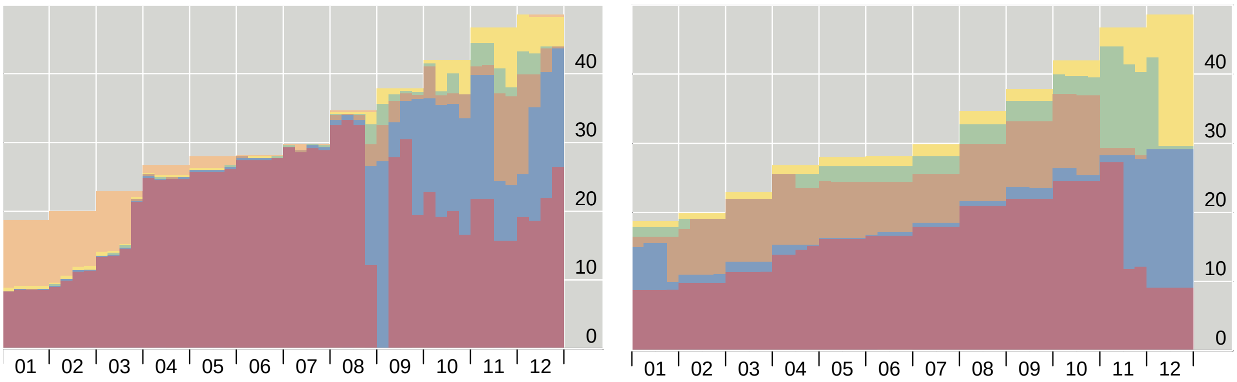
Let me extend a warm welcome to all the participants in this BIS seminar on sovereign risk. In these brief introductory remarks, I would like to provide you with an outline of the seminar and to pose some questions for the next day and a half. At the same time, I cannot resist an aside on the origins of credit risk.

The Latin root of credit is *credere*, the infinitive form of *credo*. John Maynard Keynes described credit in 1943 as the "miracle . . . of turning a stone into bread". And credit can indeed do great things, whether extended to sovereigns or to the private sector.

Recently, however, there has been too much of a good thing, contributing to a signal increase in systemic risk. As noted by the *BIS Annual Report* last June, the pool of top-rated sovereign debt within the OECD has diminished considerably over the past few years and it has also become more concentrated by issuer (see burgundy-coloured area in Graph 1, right-hand panel below).

Credit risk profile of the pool of general government debt[1]

In trillions of US dollars | Graph 1



[1] Total outstanding for OECD countries. The debt levels used are year-end observations. End-quarter observations are used for the CDS spreads and ratings. [2] The ratings used are simple averages of the foreign currency long-term sovereign ratings from Fitch, Moody's and Standard & Poor's.

Sources: Bloomberg; Markit; national data; BIS calculations.

The sovereign credit quality of advanced economies has deteriorated rapidly over the past few years. And it will be difficult to improve that trajectory any time soon, given the modest outlook for growth, lingering fragilities in the financial system and still high levels of private indebtedness. Over the past five years, public debt in the advanced economies has jumped from about 75% of GDP to 110%, with

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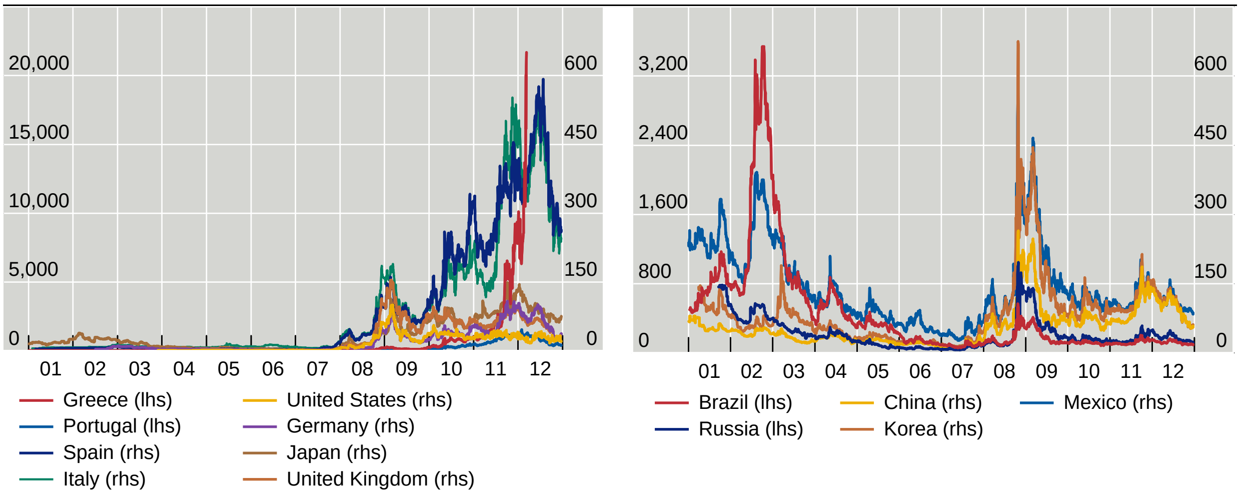
a further increase foreseen before it stabilises in 2014. And this is the optimistic rather than the pessimistic scenario.

Fortunately, the sagging ratings of OECD sovereigns (Graph 2, lower left-hand panel) have not been mirrored by developments outside the OECD. In fact, the underlying fundamentals as well as the ratings of emerging sovereigns are generally strengthening (Graph 2, lower right-hand panel).

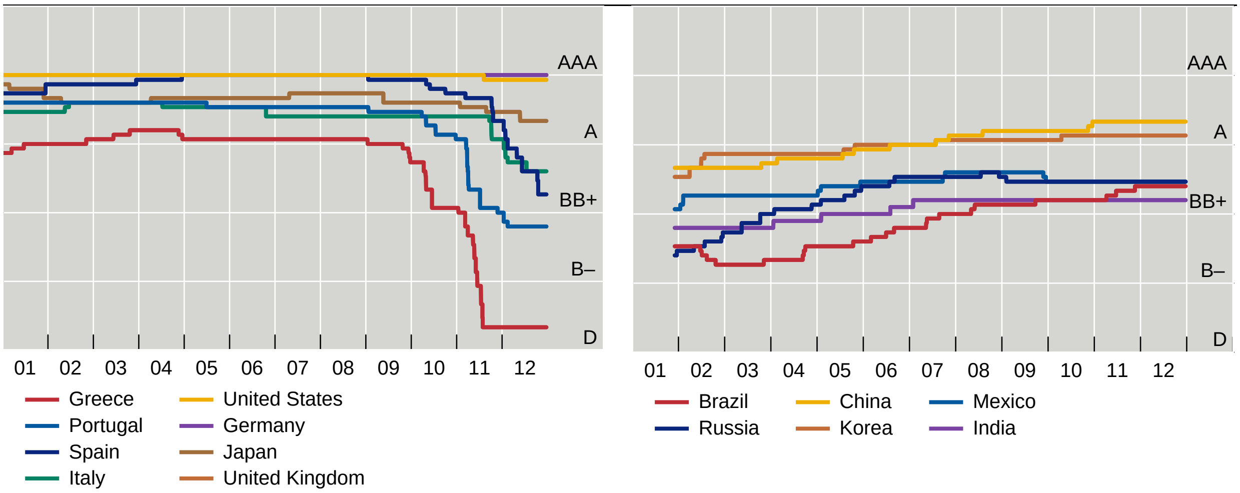
Sovereign CDS spreads and credit ratings — Graph 2

Advanced economies — Emerging economies

CDS spreads, in basis points[1]



Sovereign credit ratings[2]



[1] Five-year on-the-run. [2] Daily averages of long-term foreign currency credit ratings from Fitch, Moody's and Standard & Poor's.

Sources: Bloomberg; Markit; BIS calculations.

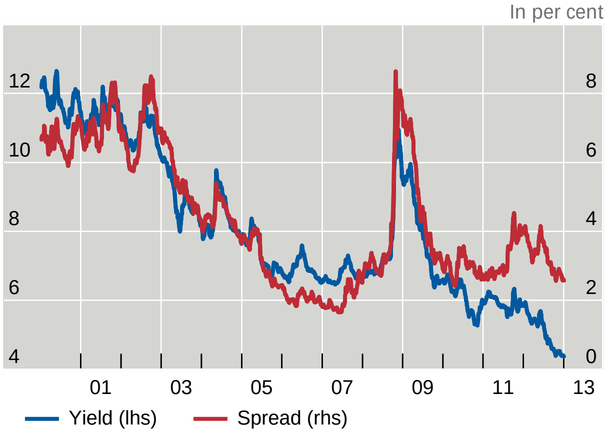
Graph 3, left-hand panel, shows how emerging market international bonds have dramatically narrowed their spreads over US Treasury yields (shown in red with the scale on the right-hand side), falling almost to their pre-crisis lows. At the same time, owing to rock-bottom base rates, their absolute yields (shown in blue with the scale on the left-hand side) are plumbing all-time lows.

The right-hand panel of Graph 3 plots ratings at the turn of the century on the horizontal axis against the ratings as at 3 January 2013 on the vertical axis. On this graph, countries above the 45-degree line have enjoyed upgrades while those below the line have been downgraded. This graph shows that the emerging markets, shown in red, have enjoyed upgrades (with some exceptions in central and eastern Europe) while the advanced markets, shown in blue, have at best retained their ratings and in most cases have suffered downgrades.

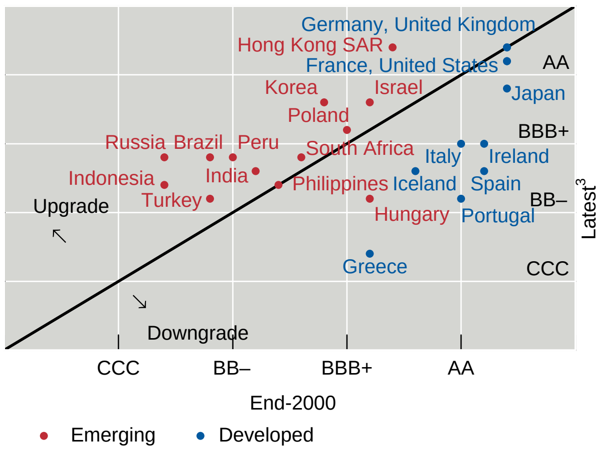
Performance of sovereign credits

Graph 3

Emerging markets international bond yields and spreads[1]



Developed and emerging sovereign credit ratings[2]



[1] Five-day moving averages. [2] Long-term foreign currency debt. [3] 3 January 2013.

Sources: JPMorgan Chase; Standard & Poor's.

If this deterioration in sovereign credit quality is not stopped and reversed, the financial and economic stability implications will be far-reaching. They will raise significant policy challenges, including the threat of fiscal dominance, additional obstacles for monetary policy exit strategies to overcome, diminished scope for backstopping the financial system or running countercyclical policies, and the potential for heightened and damaging feedback between sovereign and financial system risks. These challenges require analysis from different perspectives and their magnitude will depend on many elements, not only on the amount of debt and deficits, but also on the distribution of holders, a country's external position, and many other factors.

In this seminar, different perspectives will be represented in different panels. In the first panel, three central bank governors will discuss some of these risks and challenges, drawing on their own varied experiences.

The sovereign rating business

In the second panel, we will consider the sovereign rating business. This is not the first time that the BIS has hosted a discussion of ratings by governors. These discussions have been uniformly vigorous. It is easy to see why central bankers readily engage on this issue. For instance, in managing reserves, there is a question how much central banks can or should rely on ratings to allocate their funds. And so on.

Panel 2 will engage with certain fundamental questions that have arisen about the sovereign rating business.

- As Governor Honohan will argue in Panel 1, market participants can go from paying little attention to sovereign credit risk or even ratings to paying a lot of attention to them, perhaps too much. How should one interpret the rapid downgradings of sovereigns that was a feature of the Asian financial crisis and the more recent sovereign strains in Europe?
- What do sovereign ratings mean? How should we think about sovereign ratings with so little recent history behind them? In particular, does a given sovereign rating mean the same as an identical rating as applied to a firm? Do rapid sovereign downgrades reflect the real changes in risk or identified uncertainties ("known unknowns") or do they capture the sudden recognition of new but previously underappreciated risks ("unknown unknowns").
- How should central bankers regard the widespread view that the sovereign debt of countries in a monetary union is more risky – other things being equal – than that of other countries?
- What is the relationship between sovereign risk and high levels of private debt?
- How to avoid cliff effects?

Financial markets without a risk-free sovereign

Panel 3 will discuss financial markets without a risk-free rate, an extreme scenario. Let me be clear that a world of financial markets without something approximating a risk-free sovereign strikes me as a world that would be very complex, and one that we would not want to live in. The reasons for this view are set out in last June's *BIS Annual Report*, specifically in its commentary on the Committee on the Global Financial System's Panetta Report that highlights concerns about financial instability, the effectiveness of monetary and fiscal policy, and spillovers to the private sector.

To be sure, risk-free must be understood as a behavioural concept. As Governor Gudmundsson will argue, there is no such thing as a risk-free asset, strictly speaking. However, we used to live in a world where sovereign risk was so low that investors could behave as if that debt was risk-free. The situation was a bit like air travel: we all know that the risks are not zero when we get on a plane but they are low enough for most of us behave as if they were truly minimal.

The plight of countries that lose their risk-free status underlines the importance of retaining or regaining some kind of risk-free asset. But what would the world look like if sovereigns were unable to win back their all-but-risk-free status? The consequences could be far-reaching. Let me make two points. First, even when there is only a slim chance of default, financial markets can work very differently when sovereign risk comes into play. The policy implications and challenges will be significant.

Second, we are forced to rethink the role of public securities as the risk-free asset in providing pricing benchmarks. The lack of a risk-free rate can lead to distortions and misalignments in asset prices.

- Quite a few questions confront Panel 3 under this heading. In a world without risk-free assets, where do private market participants go when they seek a flight to quality? Would funds flow suddenly and disruptively through foreign exchange markets in search of a handful of remaining safe havens?

- Can banks safeguard their liquidity if government debt becomes just another risky asset?
- How will financial markets respond to any shortage of collateral?

Legal perspectives

Let us move on to legal perspectives. Global financial stability is best served when sovereign bond contracts offer appropriate solutions to any problems that sovereigns may experience in servicing their debt on the original terms. Recent events have put the spotlight on the *pari passu* clause, a boilerplate phrase about which we shall hear more tomorrow.

But the more pertinent question is whether sovereign bond contracts contain collective action clauses, which allow a majority or qualified majority of creditors to force a debt restructuring on minority holders. Such clauses are now more often appearing in New York sovereign dollar issues. This is good news, especially if one shares the concern that international bond investors are providing credit on too easy terms, especially to new sovereign borrowers.[2]

Since no general legal insolvency framework applies to the default of a sovereign, tomorrow's legal panel will also shed light on the following questions:

- When is there a sovereign default? A general suspension of payments obviously qualifies, but what about the non-payment of only a part of the sovereign debt?
- What is a selective default – has a default already occurred when a CDS is triggered?
- How should different creditors of the sovereign be treated? And what exactly does *pari passu* mean?
- Since a sovereign issuer generally proposes a debt restructuring to its creditors with a view to maintaining its market access, how could an orderly process be organised – as proposed by the IMF and others – to prevent hold-out creditors from disrupting external debt restructurings?[3]

Panel 4 tomorrow morning will try to answer these complex legal questions in the light of recent financial and judicial developments.

The dinner talk tonight will meanwhile ask whether the infrastructure for sovereign debt difficulties is robust.

- Is the market well prepared for the contingency that is built into the spreads?
- What could be done to improve matters?

[2] K Saigal, "Mongolia issue sets off EM bond bubble concerns", *Euromoney*, 10 December 2012.

[3] See the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution, *Report* dated October 2012 to the Group of Trustees chaired by Governors Carstens, Noyer and Zhou and former Governor Fukui.

Sovereign risk management in financial institutions

Panel 5 will look at sovereign risk management in financial institutions. It is a myth, repeated in today's *Wall Street Journal,* that the Basel rules have weighted sovereign risk, or at least some sovereigns' risk, as officially zero.[4] This is one of those "facts" that is proven, almost, by the sheer force of repetition. To be sure, Basel I drew a crude distinction between OECD and non-OECD sovereigns. But Basel II called on banks to make a granular and defensible assessment of each exposure. Basel II requires capital allocations to be sensitive to default risks even when these are small and difficult to assess. It is also true that supervisors of a given country or region could authorise exceptions, which may have departed from these norms of risk-sensitivity and granularity, especially if sovereign debt was funded in the same currency. But the framework of Basel II requires that the capital held should be proportional to risk.

That said, it is no easy matter to fold sovereign risk into a bank's or an insurance company's credit risk management. As sovereign defaults remain thankfully rare, a sovereign's default probability has a large element of uncertainty built in; it is not straightforward to estimate like, say, the risk of mortality. For instance, there have been no cases of an investment grade sovereign entering default in the past year. This is clearly unlike the case of investment grade companies, which default many times more frequently.

But just because there is no consensus, just because the problem is difficult, just because any approach is unsatisfactory, risk managers cannot indefinitely hide behind the practice of zero weighting. Stress tests may have a role to play here.

In this panel, we will hear how financial institutions are tackling or could tackle these intractable problems. The questions will include:

- How should sovereign risk be integrated into financial institutions' risk management?
- Do multinational financial firms with strong subsidiary structures in different countries experience tensions between the central, home-country perspective and several host-country subsidiary perspectives?
- How should a financial institution assess default probabilities, especially those of highly rated sovereigns? How do they in practice?
- What special aspects of this problem, if any, are relevant to central banks?

Again, this is but a summary of a very full agenda for us. Let me thank you for your active participation. I am sure that you will come up with better questions than I have. As we may have to live with higher credit risk in the sovereign world for some time, I earnestly hope that we can reduce that risk, but a lot of work remains to be done if we are to succeed.

4 H Hannoun, "Sovereign risk in bank regulation and supervision: Where do we stand?", speech at the Financial Stability Institute High-Level Meeting, Abu Dhabi, United Arab Emirates, 26 October 2011.