The regulatory treatment of sovereign exposures
Reaction of Dutch Ministry of Finance to Basel Committee on Banking Supervision

1. Introduction

We thank the Basel Committee on Banking Supervision (BCBS) for its discussion paper on the regulatory treatment of sovereign exposures.[1] The Dutch Ministry of Finance (MoF) considers a revision of this treatment an important element to come to a more risk-based prudential framework for banks and would strongly encourage further work by the BCBS in this field. The treatment of sovereign exposures is currently insufficiently encapsulated in the prudential framework, thus making the financial system more susceptible to market developments and losses from sovereign exposures. We have studied the ideas of the BCBS with interest and reflect on the main points in this paper. Whilst underlining the importance of global regulatory efforts and standards, the Dutch MoF is of the opinion that within a banking union and/or monetary union the issue of sovereign risk has special significance. As such, we will encourage the discussion on the appropriate treatment of sovereign risk within European fora as well, thereby seeking convergence with the work of the BCBS where possible, but exploring the need for further measures in a regional context where necessary.

2. Sovereign risk and the banking system

We thank the BCBS for their reflection on the different channels through which sovereign risks can manifest itself in the financial system. The exposure of a bank to a sovereign goes beyond the direct exposure on its balance sheet. Banks can equally be affected in their funding position as a result of credit quality downgrades of the sovereign and subsequent changes in the valuation of collateral. A downgrade of the sovereign can also have ripple effects on the credit quality and capital requirements of other assets because of the 'sovereign ceiling'. In addition, it is important to point out that the causality of contagion can flow from banks to the sovereign. This holds true in particular if there is no credible resolution strategy without using public money, or when banks' capital positions negatively impact the wider economic environment in a country. A robust prudential framework should facilitate and incentivize the appropriate pricing of risks and hence mitigate contagion effects whilst recognizing the central role sovereign exposures play in financial markets and the transmission of monetary policy.

It is evident that risks to financial stability become more pronounced when banks have large sovereign debt holdings in relation to their regulatory capital. Research indicates that in the Eurozone – despite the ample opportunities for diversification without incurring currency risk or hedging costs - a 'home bias' is present. The weighted average of the sovereign holdings of banks in the Eurozone towards their own 'home country' is above 100% of their tier-1 capital[2]. It has been argued that the home bias of financial institutions can act as a shock absorber if market pressure on the sovereign rises. We wish to point out that such shock absorption cannot be maintained on a structural basis if economic conditions deteriorate whilst it does reinforce the bank-sovereign contagion channels and also runs the risk of crowding-out allocation of credit to the private sector. Decoupling the risks between banks and sovereigns is, furthermore, important to ultimately enable an orderly restructuring of sovereign debt where appropriate. Furthermore, the role of banks as stable investors in sovereign debt is not fundamentally at odds with an adequate and risk sensitive risk weighting of that debt, but depends more on the specific calibration of the prudential treatment. Therefore we would welcome a debate on the specific calibration that, on the one hand, recognizes the special position of sovereign debt, but also considers the risks attached to it.

3. Evaluation of policy options

The BCBS discussion paper outlines a number of ways to improve the prudential treatment of sovereign debt to address the credit and concentration risk of sovereign exposures. From our point of view, a starting point for the discussion should be that any changes to the treatment of

[1] Basel Committee on Banking Supervision, *The regulatory treatment of sovereign exposures - discussion paper* (7 December 2017). https://www.bis.org/bcbs/publ/d425.htm.
[2] Veron, N. (Bruegel), *Sovereign Concentration Charges: A New Regime for Banks' Sovereign Exposures*, (17 November 2017), http://bruegel.org/2017/11/sovereign-concentration-charges-a-new-regime-for-banks-sovereign-exposures/

sovereign debt should not result in an effectively lower capital requirement than under the current regulatory framework.

3.1. Application of positive risk weights to sovereigns and related entities

Currently, the SA-approach already has positive risk weights for sovereigns and central banks with a credit quality lower or equal than A+. In practice, the national discretion to apply a risk weight of 0% is often exercised which allows banks to deviate from these requirements for exposures to their 'home sovereign'[3]. Notwithstanding the current capital treatment, sovereign exposures are not risk free as also recognized by the Committee. Whilst the Probability of Default (PD) on sovereign exposures remains comparatively low (but non-zero), the main risk of sovereign exposures is the large Loss Given Default (LGD) when a default occurs.[4] We see room to improve the current SA-approach by applying a more granular model for classifying sovereign exposures that could also take into account other factors in addition to ratings. We think a revised SA-approach should allow for sufficient differentiation as a more granular approach also mitigates cliff effects between classifications/ratings. We do not think a flat risk weight for sovereign exposures is appropriate because the heterogeneous level of risk would not be captured (a similar issue would arise when solely relying on concentration charges). A revision of the Standardised Approach (SA) for the treatment of sovereign debt would eventually pave the way for phasing out the current Internal Ratings-Based (IRB) approach for sovereign exposures. We agree with the observation made by the BCBS that the treatment of sovereign debt should not be left to internal models of banks because this would result in questions over the robustness and consistency of requirements. The Dutch MoF therefore argues for a phasing out of the discretion to use the IRB-model for sovereign exposures. This step is, however, strictly conditional on a revision of the SA-approach for sovereign exposures. Otherwise lower capital requirements for sovereign risk than under the current IRB approach – despite its shortcomings – could be the result.

3.2. Concentration charges

In addition to addressing credit risk, the average relative size of sovereign exposure to regulatory capital of banks make it necessary to also look at concentration risk as the BCBS has done. Based on 2017 data, banks in European Member States on average hold 6.78% of their total exposures in sovereign bonds issued by their home country.[5] In our view, the prudential framework should incentivize banks to diversify and lower their exposures to a single sovereign. When capital requirements increase with higher sovereign exposures, eventual price movements of sovereign bond holdings will have less severe effects on banks' (increased) capital buffers. The concentration risk on bank balance sheets could be priced by a progressive marginal risk-weight relative to the exposure size to each individual sovereign. This add-on should then start with escalating risk weights materially below the size of the regulatory capital of banks and could subsequently be calibrated for different buckets on the basis of the relative exposure to a particular sovereign. From that perspective the examples of the calibration of concentration charges provided in the BCBS discussion paper require further work.

3.3. Complementary actions

Complementary to the measures discussed above other actions could be considered as a no-regret. The first point is related to the definition framework. We advocate the need for a clear definition on what qualifies as a (connected) sovereign entity. We recognize the important technical work in the BCBS discussion paper on issues regarding definitions. Agreement on this aspect can be a foundation for the application of a more robust prudential treatment of sovereign exposures. The second point concerns the Pillar II and Pillar III framework. Developing a framework of Pillar II guidance on monitoring and stress testing of sovereign risk as well as further strengthening Pillar III disclosure requirements could be necessary to improve the resilience of the current capital framework and allow for a more effective disclosure of risks.

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[3] EU authorities have set a zero risk weight for sovereign exposures denominated and funded in the currency of the corresponding Member State, but also for exposures denominated and funded in the currencies of other Member States. This treatment for exposures denominated in a different currency will be gradually phased out.

[4] See aforementioned BCBS discussion paper (2017) p. 7-9.

[5] European Parliament*, Banks' exposures to Home sovereign bonds,* (February 2018), http://www.europarl.europa.eu/RegData/etudes/ATAG/2016/574391/IPOL_ATA%282016%29574391_EN.pdf

4. Conclusion

Sovereign exposures, in particular through the bank-sovereign nexus, imply risks for financial stability, whilst the current framework unfortunately does not adequately capture these risks. We are therefore in favor of strengthening the prudential treatment by introducing positive risk weights that differentiate between sovereigns on the basis of credit risk, as well as commensurately increasing capital concentration charges to be applied in relation to single sovereign holdings. These two measures complement each other to fully reflect the risk related to sovereign exposures: they differentiate in the risk attached to an individual sovereign as well as the concentration risk that can impede an orderly restructuring of sovereign debt when and where needed. The calibration of these measures should naturally take into account that government debt also plays an important role in the implementation of monetary policy, fiscal policy and the functioning of financial markets. We hence encourage the Committee to continue work on this important aspect of the prudential framework for banks. We will follow this work of the Basel Committee closely and also continue to work on this issue with our European partners in line with the 2016 roadmap to complete the European Banking Union[6].

[6] http://www.consilium.europa.eu/en/press/press-releases/2016/06/17/conclusions-on-banking-union/