

POSITIONS PAPER

07/03/2018

Basel Committee
on Banking Supervision

Discussion paper – The regulatory treatment of sovereign exposures

The Swedish Bankers' Association, Finance Finland and Finance Denmark (the Nordic Associations) is supportive of the general approach of the Basel paper on sovereign risk. The financial crisis has shown that government risk is a relevant risk for banks, and that it is reasonable that it is taken into account to a larger degree than today when calculating capital requirements.

Current EU efforts to create a robust financial sector for the single market will continue to be undermined by not fully recognising the risk that certain sovereign exposures pose and thereby creating poor incentives that ultimately exacerbate the sovereign-bank nexus, which is in direct conflict to the intentions laid out in recent other key pieces of globally agreed bank regulation. This is clearly not healthy for the EU or the global financial system.

When revising the current framework several aspects should be considered.

There is a balance between on the one hand taking sovereign risk into account when managing risks in banks, and on the other hand making sure that banks are not disincentivised to place liquidity in the safest assets. It is very important that banks, especially in a crisis scenario, are able to manage excess liquidity by placing it in central banks, rather than draw down their balance sheets. The proposal to view central bank placements in their own currency without any capital requirement is hence a very positive and important part of this proposal. The concept of "safe" risk free assets may have utility from a financial stability perspective and should therefore be given careful consideration when determining risk weights for (in particular) highest quality sovereign assets.

A revision of the regulatory treatment of sovereign risk should strive to create a global level playing field for banks. In particular, the discretion given to national authorities to assign zero risk-weights and zero hair-cuts to certain sovereign exposures - no matter their inherent risk – may have negative consequences from both financial stability and level playing field perspective. This is compounded by the fact that the practice of allowing zero risk-weights for sovereigns is widespread.

The current regulatory approach to sovereign risk raises a number of concerns:

1. Sovereign issuers of significantly different credit quality are treated on par in terms of capital requirements
2. Favourable treatment is often given to sovereign assets relative to other asset classes

It is important for sovereign borrowers, banks and other market participants that there is a high degree of predictability and consistency in the capital requirements for sovereign risk. Hence the Nordic Associations does not favour a Pillar II measure as it introduces significant national discretion – which may lead to a continuation of an un-level global playing field for banks.

We encourage the BCBS to take into consideration the potential for very different risk dynamics between banking book and trading book assets when calibrating the parameters for sovereign risk. This is particularly important for the default risk charge applied to trading book assets. We also encourage the BCBS to avoid creating material inconsistencies between the market and credit risk frameworks when revising the treatment of sovereign risk. A particular challenge is the current PD floor in the market risk default risk charge.

Furthermore, we do not think that sovereign exposures should be treated differently in the large exposure regime. We are concerned that a cap on sovereigns in large exposures would have significant negative consequences for the ability to meet the liquidity requirements.

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?

In certain countries a very significant part of sovereign exposures are due to the sovereign, or in some countries state agencies role, as mortgage guarantor. We don't see that these exposures are described in the discussion paper. We fear that if sovereign mortgage guarantees were to be treated as any other direct exposure towards the sovereign, it would result in a significant overestimation of capital requirements for such exposures. It is worth noting that state mortgage guarantees contain both a double default element and a (low) CF factor element. In other words, first the mortgagor must default on his mortgage. Then the mortgaged real estate must be sold off and only thereafter the claim can be made against the mortgage guarantor. In other words, we see a risk here which is much lower than a direct exposure to the sovereign and we urge that due consideration for such cases is incorporated into the next discussion paper.

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?

The second criteria for non-central government exposures is too vague to be appropriate for such an important definition. Further clarification of indicators is needed regarding non-central government exposures.

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?

To be consistent with the removal of certain IRB models in the final Basel III package for some low default probability exposures, the use of IRB models for sovereigns should also be removed.

Sovereign credit risk is even harder to estimate and model than the other exposure categories where the use of certain IRB models is no longer allowed. We are of the opinion that sovereign exposures should be subject to a standardised approach under Pillar 1.

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?

In recommending the standardised approach we stress that the calibration should need to be sufficiently risk sensitive and granular. Further, we are of the view that zero (or close to) risk weights will not be appropriate in a number of circumstances, as not all sovereign assets can be considered risk free. Overall, the proposed risk weights look high and in particular for the foreign currency debt for well rated sovereigns. We would like to point out that subsidiaries of banking groups in third countries should treat their exposures in local currency according to the local currency rating and this should be the case at consolidated level as well. Furthermore, jurisdictions with fixed exchange rate regimes in the EU should be able to qualify for treatment similar to domestic currency central government exposures.

Capital requirements that are comparable and risk sensitive are essential for sound capital allocation and pricing decisions within the financial industry. Sufficient risk sensitivity will also reduce potential cliff effects. It is therefore important that the standardised approach is granular and reflects the underlying risk of the asset.

Overnight deposits and short-term certificates which are primarily used for handling liquidity portfolios pose a lower risk than long term commitments and it should be reflected in risk weights and capital allocation.

Q8. What role could specific non-rating indicators play in determining sovereign exposure risk weights in the potential standardised approach?

External ratings should be used. Most sovereign borrowers are rated and the rating methodologies deployed typically rely on verifiable objective criteria or indicators.

Regarding other sovereign exposures, when the rating is unavailable, we are of the opinion that both the described risks and methods are ill-suited for regional governments and local authorities. The most common reason for the default of regional governments and local authorities is 90 days past due situation. This is often due to administrative challenges which have little connection to the risks mentioned. This reflects that non-central governments often rely on leasing and credit lines while for central governments do not.

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