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Sovereign risk weights: the big missing piece of Basel III

Scope Ratings

Concerns about bank-sovereign links, which resurfaced in recent weeks, have pushed policy deliberations in this area to the fore. For now, banks will continue to apply 0% risk weights to sovereign exposures on their balance sheets.

Heightened volatility in Italian government bonds recently on the back of political changes; the more limited uncertainty around the recent Spanish government change; and what happens when the ECB ends its Public-Sector Purchase Programme (PSPP) all turned the market's attention back to a theme that has still not been addressed: European bank holdings of EU sovereign debt, particularly their impact on bank stability and solvency during times of market stress. As of June 15 2018, the ECB had a little over EUR 2 trillion in holdings under its PSPP.

After years of heavy debate, regulators supposedly finalised Basel III late last year with a 2022-2027 implementation schedule. Except it is not final because one major area is still missing in action: sovereign risk weights. "At the point at which any sovereign started to show stress, unfinished work in this area was always going to present challenges," said Sam Theodore, team leader for financial institutions at Scope Ratings.

A sovereign showing signs of distress can visibly pollute the balance sheets of banks with large holdings of government debt; not so much in accounting or risk-control terms (accounting treatments are no different and banks are not going to start taking provisions against EU sovereign debt) but in terms of market sentiment and perception.

Stressed market conditions and poor sentiment can constrain access to market funding and equity-raising for banks with large sovereign portfolios, while contagion effects can affect even banks that do not have large exposures.

When discussions about sovereign risk-weights for banks kicked off at the height of the sovereign crisis, the idea was to adjust them on the basis that not all countries are equally risky. But the discussion went nowhere. In the meantime, the sovereign crisis abated and the debate went onto the back burner.

"There was a realisation that formally embedding into bank regulation the notion that some countries in the EU are riskier than others was too political to be addressed solely by regulators. The issue became a political hot potato for policy makers who didn't want to grasp the nettle of having to rank countries by risk for bank risk-weighting purposes," said Theodore.

Awaiting Basel

The Basel Committee on Banking Supervision's conclusions on this issue will be very relevant in this respect. The Committee is starting from the premise that while sovereign exposures carry risk, they also play a key role both in banking and financial markets (liquidity management, credit-risk mitigation, asset pricing, financial intermediation, investment) and in the economy (conduct of monetary and fiscal policy). Hence, they understandably see a need to balance prudential risk with other financial stability matters.

Increasing risk-weights, therefore, presents something of a conundrum. Specifically, banks are heavily incentivised – through zero risk-weightings, exemption from large-exposure limits and zero haircuts on eligible assets – to load up on sovereign debt. This is a stark contradiction of regulatory oversight.

Analyst

Sam Theodore
+44 20 3457 0452
s.theodore@scoperatings.com

Media

André Fischer
+49 30 27891 147
an.fischer@scopegroup.com

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 (0)20 3457 0444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Level 1 assets for Liquidity Coverage Ratio purposes, for example, include marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs, the BIS, IMF, ECB, European Community, or MDBs *that are assigned a zero risk-weight under the Basel II Standardised Approach for credit risk*. (Scope italics).

“The new liquidity regulations have boosted this aspect as they require large cushions of High-Quality Liquid Assets, whose main component is sovereign exposures. And not surprisingly most banks tend to have the bulk of their sovereign portfolios in debt of their home country. The size of cross-border portfolios even of large international banks is much reduced since the crisis,” said Theodore.

Banks are being encouraged to break home-country bias through asset diversification. Banking Union and Capital Markets Union, as well as a probably unreachable eurozone-wide deposit-protection scheme, are often put up as potential solutions. Pushing European banks to reduce heavy home-country bias in their holdings of government bonds in favour of a more diversified pan-regional portfolio approach remains an uphill battle, however. And in practice forcing sovereign portfolio diversification may have a perverse effect, as non-domestic holders typically exit first once distress hits away from home.

“The reality is, after the crisis we have less of a single market than in the years before it. Banking is still conducted along national lines, and operating frameworks vary from country to country. Banks switching their modus operandi and carrying out activities along EU lines is still aspirational. A global capital market, with components that are already working, and the EU single market are different things,” said Theodore.

Are the proposals workable?

The Basel Committee on Banking Supervision proposed three sets of broad ideas in its December 2017 discussion paper. The first set would remove the internal ratings-based framework for sovereign exposures; introduce positive standardised risk weights for sovereign exposures held in banking and trading books based on a look-up table (removing national discretion to apply preferential risk weights for sovereign exposures denominated and funded in the domestic currency of the issuer); and amend the credit-risk mitigation framework (removing national discretion to set a zero haircut for certain sovereign repo-style transactions).

The look-up table would lay out risk-weights for exposures to a sovereign entity. These would vary based on the external credit rating of the sovereign entity or using the OECD’s Country Risk Classification (CRC) score.

Table 1 Example of standardised risk-weights for sovereign exposures

External rating	Triple A to Single A minus	Triple B plus to Triple B minus	Below Triple B minus and unrated
OECD CRC	0-2	3	4-7 and no classification
Central bank exposures (a)	0%		
Domestic-currency central government exposures (b)	[0-3]%	[4-6]%	[7-9]%
Foreign-currency central government exposures (c)	10%	50%	100%
Other sovereign entities (d)	25%	50%	100%

(a) Defined as exposures to central banks denominated and funded in domestic currency and exposures to central banks in jurisdictions where monetary policy is centred on the exchange rate. Other central bank exposures (e.g. equity exposures to a central bank) should be treated as domestic or foreign-currency central government exposures, depending on the denomination and funding of the currency

(b) Domestic-currency exposures defined as exposures that are denominated and funded in the currency of the sovereign entity. Includes domestic-currency other sovereign exposures which meet the equivalence criteria (autonomy or support) and international organisations and MDBs that are currently subject to a 0% risk-weight. Banks should use the rating of the other sovereign entity if the "autonomy" criteria are met. Banks should use the rating of the central government or autonomous subnational government if the "support" criteria are met.

(c) Includes foreign-currency other sovereign exposures which meet the equivalence criteria (autonomy or support). Banks should use the rating of the other sovereign entity if the "autonomy" criteria are met. Banks should use the rating of the central government if the "support" criteria are met

(d) When rated, based on the rating of the sovereign entity or its central government (whichever results in the higher risk-weight).

Source: Basel Committee on Banking Supervision

To reduce mechanistic reliance on external credit ratings, Basel suggested banks could be required to perform detailed risk due-diligence on their exposures to sovereign counterparties (which could result in a higher risk-weights than implied by the rating/CRC). The Committee also discussed non-rating indicators, such as macroeconomic and fiscal variables, and/or credit aggregates.

As a second stream, the Committee discussed whether to maintain sovereign exemptions from the large exposures limit of 25% of a bank's Tier 1 capital, or to consider alternative methods to prevent banks from having heavily-concentrated exposures to individual sovereigns. One method would be to impose marginal risk weight add-ons based on the degree of a bank's concentration to a sovereign relative to its Tier 1 capital.

Table 2 Example of marginal risk-weight add-on table for sovereign exposures

Exposure to group of connected sovereign counterparties (% of Tier 1 capital)	< 100%	100-150%	150-200%	200-250%	250-300%	>300%
Marginal risk-weight add-on	0%	5%	6%	9%	15%	30%

Source: Basel Committee on Banking Supervision

Table 3 Example of marginal risk weight add-on approach

Sovereign exposures	Units	Scope of sovereign counterparties	Sovereign exposures (% of Tier 1)	Marginal risk-weight add-on
Tier 1 capital resources	*100*			
Central government A	120	✓	(120+30)/100 = 150%	0% for first 100 units 5% for subsequent 50 units Effective average risk-weight add-on of 1.67%
Sovereign A entities meet "support" equivalence criteria	30			
Sovereign A entities meet "autonomy" equivalence criteria	150	✓	150/100 = 150%	0% for first 100 units 5% for subsequent 50 units Effective average risk-weight add-on of 1.67%
Central government B	200	✓	200/100 = 200%	0% for first 100 units 5% for next 50 units 6% for subsequent 50 units Effective average risk-weight add-on of 2.75%

Source: Basel Committee on Banking Supervision

The third set of ideas related to Pillar 2 and Pillar 3 treatments. For Pillar 2 (supervisory review), this related to guidance on monitoring, stress testing and supervisory responses to mitigating sovereign risk. Pillar 3 (disclosure) ideas related to disclosure requirements regarding banks' exposures and risk-weighted assets of different sovereign entities by jurisdiction, currency and accounting classification.

“What has been suggested makes sense. Regulators do need to discourage banks from holding excessive amounts of bonds of their domestic sovereigns. The only viable way of doing this is to impose higher risk-weights, either from the get-go or, more realistically, via gradual increases if exposures go above a certain percentage of a bank's capital. With proper calibration, the economics of excessive single-sovereign exposures -become less evident,” said Theodore.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

33 rue La Fayette
F-75009 Paris

Phone +33 1 82 88 55 57

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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Scope Ratings GmbH, Lennéstrasse 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Torsten Hinrichs.