Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Can regulatory changes mitigate the sovereign-bank nexus?

18th Annual International Conference on Policy Changes for the Financial Sector

Washington DC – 7 June 2018

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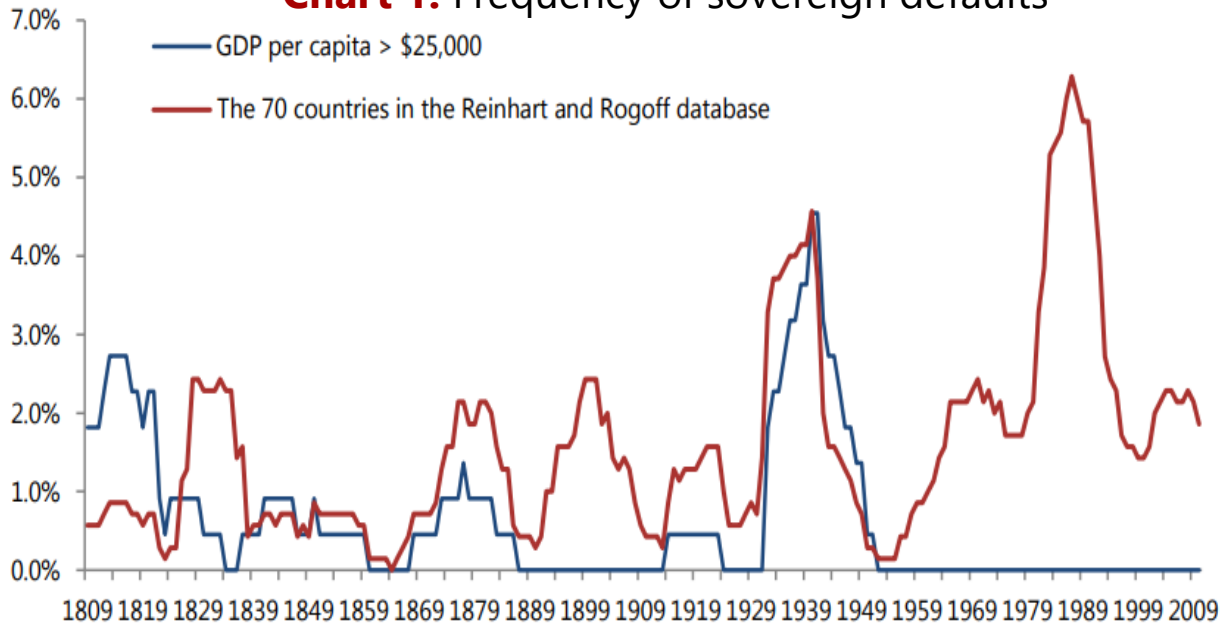
Regulatory treatment of sovereign exposures

- "Discussion Paper" published in December 2017
- Outcome of careful, gradual and holistic review
- No consensus to change existing treatment
  - But recognition that issues would benefit from broader discussion
  - BCBS solicited views of stakeholders to inform longer-term thinking
- Comment period ended 9 March 2018

Sovereign risk

- What's the issue? Ans: Sovereign exposures have risks (see Chart 1)
- Banking crises have led, accompanied and followed sovereign crises
- Existing regulatory treatment more favourable than other assets
- Sovereigns play special role:
  - Financial markets
  - Monetary policy
  - Fiscal policy

Chart 1: Frequency of sovereign defaults[(a)]



Source: Reinhart and Rogoff (2011) and Secretariat calculations.
(a) The frequency of default is defined as the ratio of the number of new defaults in a given year over the total number of countries in the sample. The graph shows the average frequency of default over 10-year moving windows. The definition of default includes episodes in which debt is ultimately extinguished in terms less favourable than the original obligation. The data end in 2010, which means, for instance, that the recent Greek sovereign distress episode is not included.

Regulatory treatment of sovereigns generally more favourable

- Credit risk
  - Standardised approach: National discretion for preferential default risk weight for sovereign exposures denominated and funded in domestic currency
  - IRB approach: sovereign exposures exempt from 0.03% PD floor
  - Credit risk mitigation: National discretion to apply a zero haircut for repo-style sovereign transactions with core market participants
- Market risk (revised framework)
  - Standardised approach: National discretion for preferential default risk charge
- Large exposures framework: sovereign exposures exempt
- Leverage ratio framework: sovereign exposures included
- Liquidity standards: No limits on domestic sovs as HQLA; no haircuts

“Ideas” discussed by Basel Committee

- Revisions to risk-weighted framework
  - Positive standardised risk weights
  - Removal of IRB approach
- Mitigating concentration risk
  - Marginal risk weight add-ons based on concentration to sovereign exposures
- Other revisions considered
  - Definition of sovereigns
  - Revisions to credit risk mitigation framework
  - Pillar 2 guidance
  - Pillar 3 disclosures

Current standardised approach

Credit assessment	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to B–	Below B–	Unrated
Risk weight	0%	20%	50%	100%	150%	100%

Alternative standardised approach for sovereign exposures?

External rating	AAA to A–	BBB+ to BBB–	Below BBB– 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 (eg 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).

Reducing excessive concentration to sovereigns

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%

- Initial threshold of 100% Tier 1 capital (holistic role of sovereign exposures)
- Group of connected sovereign counterparties based on equivalence criteria

Example of marginal risk weight add-ons

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			

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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%

Questions? Reactions? Responses?

BCBS discussion paper on sovereign exposures:
www.bis.org/bcbs/publ/d425.htm

BCBS webpage:
www.bis.org/bcbs