

Which supervisory or regulatory treatment of banks' exposures to sovereign risks?



In his [answer](#) to the European Parliament (EP), Commission's Executive Vice-President designate V. Dombrovskis explained that "It is necessary to encourage banks to diversify further their sovereign bond portfolios and reduce the home bias, which remains far too strong and leaves banks overly exposed to the fiscal distress of their home government. I do not underestimate the political, legal and technical complexity and sensitivity of these issues across the EU and their financial stability implications, so it will be essential to develop a consensus both in the European Parliament and with the Member States".

This briefing takes stock of where the Banking Union stands in terms of sovereign exposures, home bias and concentration risks, as well as international regulatory developments (Section 1). The 2018 EP Banking Union [report](#) and the 2016 Council [roadmap](#) conditioned the adoption of an EU Regulatory Treatment of Sovereign Exposures (RTSE) to international standards to be worked out by the Basel Committee. Absent international regulatory progress, this briefing presents ways to address sovereign risks under the existing supervisory and regulatory framework (Section 2). It also provides an insight into various options identified by the European Banking Authority (EBA), the Basel Committee, the European Stability Mechanism (ESM) and the European Systemic Risk Board (ESRB) (Section 3) that might be coupled with other developments, including on a European deposit insurance scheme (EDIS) (Section 4).

The issue is currently discussed in the Eurogroup High Level Working Group on EDIS, expected to report back to the European Council by end 2019.

1. Banks exposures to sovereign risks: where do we stand?

The 2018 European Parliament (EP) Banking Union [report](#) first "Recalls that there are risks associated with sovereign debt; takes note of the on-going work of the Basel Committee on Banking Supervision (BCBS) on sovereign risk", secondly "is also concerned by the fact that some financial institutions have excessively large exposures to sovereign debt issued by their own governments", and thirdly "stresses that the EU regulatory framework on prudential treatment of sovereign debt should be consistent with international standards". This section provides a rundown of where the Banking Union (BU) stands on these three issues.

1.1 Sovereign risks

In terms of sovereign risks, the [Basel Committee](#) identified the following risks that "are multidimensional, and include credit, interest rate, market and refinancing risk (...): (i) missed payments; (ii) debt restructuring or outright defaults; (iii) currency redenomination; (iii) currency devaluations; (iv) losses from unanticipated, higher inflation; and (v) fluctuations in the value of sovereign exposures".



There is a broad consensus that sovereign exposures entail risks¹ for banks, also those in the Banking Union:

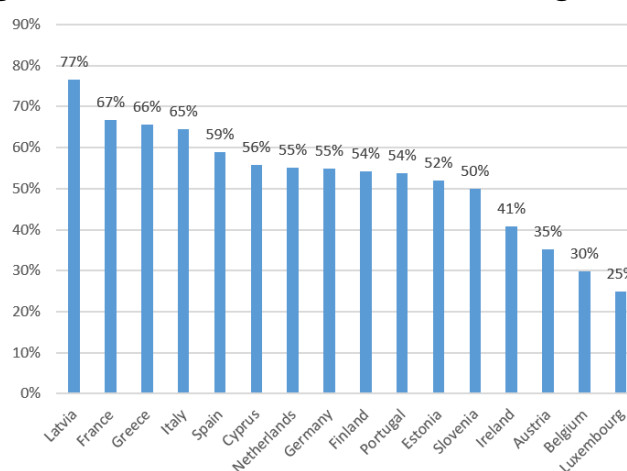
- As the [EBA](#) put it in 2016, “The lack of risk sensitivity and incentives in the prudential framework to manage sovereign risk actively may have led to complacency prior to the EU sovereign debt crisis, as empirical evidence illustrates limited diversification and significant home-bias in the holdings of sovereign assets” (...) “What is necessary is to give banks incentives to actively manage this risk and especially avoid excessive concentration of exposures towards the domestic sovereign”;
- The ESRB [report](#) on the regulatory treatment of sovereign exposures (2015) stressed that “The recent financial crisis and subsequent distress suffered by a number of sovereigns, including some EU Member States, has further highlighted these risks. Elevated levels of sovereign debt imply that such debt can no longer be regarded as having zero credit risk and may also not be liquid”;
- The European Central Bank ([ECB](#)) financial stability review of May 2019 notes that “banks’ exposures to domestic sovereign debt were broadly stable on aggregate, but some banks remain vulnerable to a possible aggravation of sovereign risk concerns.” and “Banks’ holdings of domestic sovereign debt remain elevated or have even increased since early 2018 in some euro area countries, including Italy and Portugal”.

The caveats put forward by EBA, ESRB, and ECB have over time presumably even gained importance. The Basel Committee, for example, highlights in its most recent [Basel III Monitoring Report](#) that “the share of sovereign exposures has increased steadily in recent years from 12.4% to 19.9%” while other credit exposures have declined (observation refers to a consistent sample of 36 large and internationally active banks).

1.2 Home-bias and concentration risk in the Banking Union

The term “home-bias” describes the extent to which a bank’s portfolio of sovereign exposures is concentrated in the country in which it is headquartered, rather than being diversified. In general, portfolio diversification aims to reduce the exposure to any particular risk, for example the credit risk associated with one particular country, measured by its credit rating. Diversification of sovereign exposures usually comes with an exchange-rate risk. Banks in the euro area, however, could invest into a diversified portfolio without any exchange-rate risk, by opening-up to debt from other euro-area Member States. The home-bias problem is therefore “idiosyncratic” to the euro area, as argued in a [Bruegel](#) paper commissioned by the ECON Committee². In other jurisdictions, the country coincides with the currency area, sovereign exposures denominated in a bank’s home currency are “inevitably domestic”. “What is specific to the euro area, and the problem from the standpoint of the bank-sovereign vicious circle, is the home bias within the euro area”.

Chart 1: Home-bias of significant banks, Q2 2019 (domestic sovereign debt to total sovereign debt)



Source data: ECB [Supervisory banking statistics](#); details for Lithuania and Malta are suppressed in the ECB data for confidentiality reasons, and in Slovakia, there are no significant institutions at the highest level of consolidation.

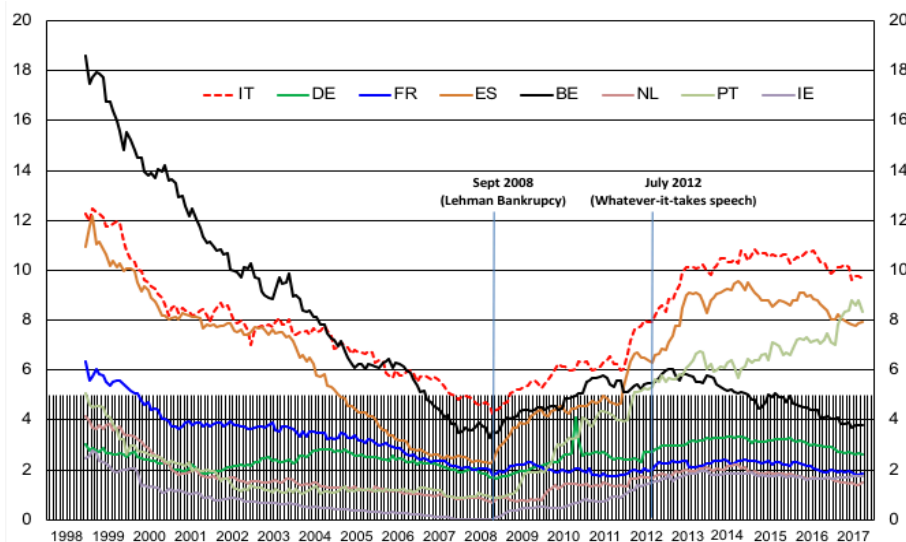
¹ In the following, the terms ‘exposure’ and ‘risk’ are used interchangeably; financial exposure is the amount an investor stands to lose in an investment should the investment fail.

² “Sovereign Concentration Charges: A new Regime for Banks’ Sovereign Exposures, November 2017, Nicolas Véron

Statistical data³ recently published by the ECB on the most significant banks in the euro area suggests that home-bias can be observed in most Member States, though there are notable differences at country level (see chart 1 above).

Home-bias translates into excessive concentration risk that has been caused, according to [EBA](#), by an inadequate regulatory framework: *“The lack of any requirements on concentration risk in the sovereign portfolio – in combination with the preferential treatment for credit risk – implies the absence of any regulatory incentives for banks to actively manage the concentration risk of their sovereign exposures”*.

Chart 2 - Banks' holding of domestic sovereign bonds (1998 - 2018)



Source: M. Lanotte and P. Tommasino, Vox CEPR Policy Portal [note](#), February 2018, Eurosystem data

As illustrated in Chart 2, banks in the Banking Union increased domestic sovereign exposures during the financial crisis (September 2008) and reduced their holding of sovereign bonds when market conditions improved. Behaviour of banks is hence “countercyclical – they sell when bond yields are low and buy when yields are high”⁴. From a sovereign perspective, banks’ holding of sovereign bonds play a stabilisation role. From a macro-economic perspective, the regulatory treatment of sovereign exposures has met with caution (See survey from Commission DG [ECFIN](#) on the doom-loop)⁵.

1.3 International developments

That stabilisation role that holdings of sovereign bonds have vis-à-vis the respective sovereign, together with other key features of sovereign bonds in the financial market, has led the [Basel Committee](#) to put the Regulatory Treatment of Sovereign Exposures (RTSE) on hold as no “*consensus [has been reached] on making any changes to the regulatory treatment of sovereign exposures at this stage*”. Even though the Basel Committee is of the view that sovereign exposures entail risks, the Basel III Final Rules leave the treatment of sovereign exposures unchanged and are only slightly impacted by the final rules governing internal

³ There is currently no obligation to disclose information on sovereign exposures; the Basel committee explores the idea to further promote the voluntary disclosure of sovereign exposures and to that end issued in November 2019 a [consultative document](#) that proposes three potential disclosure templates (breakdown by jurisdiction, currency, and accounting classification).

⁴ “Recent developments in the regulatory treatment of sovereign exposures”, M. Lanotte and P. Tommasino, Vox CEPR Policy Portal [note](#), February 2018

⁵ “Promoting pure diversification through regulatory policies should, however, be approached with caution as a review of the literature and SYMBOL simulations suggest that they can have an ambiguous effect on systemic- and bank-level risk in some cases. However, diversification of banks’ sovereign debt holdings can operate as an important mechanism for distributing the impact of shocks, a fact also confirmed in simulations using the QUEST model. Another form of achieving these positive results is through further cross-border integration of banking sectors. QUEST simulations assuming a particular form of integration (i.e., cross-border bank equity ownership) show how asymmetric shocks may be diluted across regional blocs, increasing the overall welfare of risk-averse households”

models⁶, as clarified by the [Basel Committee](#), emphasising that sovereign exposures play an important role in the banking system, financial markets and the broader economy⁷. Likewise, Commission's [consultation](#) on the Final Basel III rules does not suggest any further amendments.

In the absence of any revised international standards, the question is whether and how sovereign risk may be addressed under the existing supervisory and regulatory framework in the EU (See Section 2), and whether further regulatory developments would prove necessary (See Section 3). It must be noted that in accordance with 2016 Council [roadmap](#), "the Council agree[d] to await the outcomes of the Basel Committee" while noting that "Following the work of the Basel Committee the Council will consider possible next steps in the European context". The Eurogroup has started a political discussion on the RTSE, as part of the High Level Working Group on EDIS.

2. How to address sovereign exposures under the existing framework

As the [ESRB](#) put it, "If sovereign exposures are risky and financial firms do not pay enough attention to credit/default risk in sovereign exposures, their own solvency may be at risk. Considering that the safety and soundness of financial institutions and the stability of the financial system are an ultimate and exclusive objective of financial regulation, then prudential regulation must take account of sovereign risk if such risk exists". While sovereign risk is not "risk-weighted" or subject to haircuts as part of the Liquidity Coverage Ratio (LCR), this section explains how other prudential ratios – and more importantly Pillar 2 and stress tests – may cater for excessive sovereign risk under the existing supervisory framework.

2.1 Regulatory treatment of sovereign risks under CRR

In terms of credit risk, the Capital Requirements Regulation (CRR) has implemented the Basel framework in a less restrictive way, leaving sovereign risk largely unaddressed (see Table 1 for more details):

- As all Basel Committee members, the EU has availed itself of the discretion to apply a 0% risk-weight to sovereign "domestic" exposures (which means all Euro-zone countries in the Banking Union⁸) under the revised Standardised Approach to credit risk. In contrast, it must be noted that in the [US](#), only the "US federal state and its agencies" are 0% risk-weighted, while states are 20% risk-weighted;
- There is, however, a "cherry-picking problem" when it comes to the internal ratings-based (IRB) approach to credit risk, which in general allows banks to model their own inputs for calculating risk-weighted assets from credit exposures. To make it easier for institutions to switch to that more individual, more risk-sensitive, and less capital-demanding IRB approach, the Basel rules allow banks in exceptional cases to partially continue using the Standardised Approach for some exposures, either temporarily during an implementation phase, or permanently for certain immaterial exposures or run-off portfolios. However, the EU approach⁹ to allow a "permanent partial use" even for material exposures, allowing IRB banks to 0% risk-weight sovereign exposures, has therefore been deemed "materially non-compliant" with Basel requirements. In its [assessment](#) of the Basel III implementation in the EU (December 2014), the Basel Committee noted that "data supplied by banks indicate that the permanent exclusion of sovereign exposures from the IRB Approach generally results in a material overstatement of their CET1 ratios relative to a situation where these exposures were fully covered by internal ratings".

⁶ Affected by the removal of the 1.06 scaling factor and the inclusion into the calculation of the output floor

⁷ "Sovereign exposures are used by banks for liquidity management, credit risk mitigation, asset pricing, financial intermediation and investment purposes. Banks' holdings of sovereign exposures also play an important role as part of monetary policy operationalisation. As banks are generally one of the main investors in government debt, they also play a role in the operationalisation of fiscal policy" Source?

⁸ Because of the currency union, the exemption is automatically applicable to all banks within the euro area that finance euro-denominated government debt, leading to preferential treatment of the respective bonds in spite of differences in credit risk.

⁹ The Basel rules on partial use have been transposed into EU law, in Article 148 CRR and Article 150 CRR. Those articles give the EBA a mandate to develop rules for a standardisation of partial use requirements, but have not yet been issued. National authorities therefore use the inherent discretion to interpret in different ways as to how partial use can be applied.

Table 1 - Regulatory treatment of sovereign exposures (Pillar 1)

Requirement	Basel treatment	CRR Treatment
Credit risk under the Standardised Approach (RSA)	<p>In the standardised approach, the Basel II rules imply a risk weight of 100% by default for sovereign exposures. An assessment from a rating agency leads to a risk-weight from 0% to 150%.</p> <p>National discretion to apply a 0% risk weight for sovereign exposures denominated and funded in domestic currency, regardless of their inherent risk.</p>	<p>The CRR treatment implement the national discretion.</p> <p>According to Article 114(4) of the CRR, “exposures to Member States’ central governments and central banks denominated and funded in the domestic currency of that central government and central bank shall be assigned a risk weight of 0%”.</p>
Credit risk under the IRB approach	<p>Under the IRB approach, sovereign exposures are generally treated in a similar manner to exposures against corporates and banks. However, banks’ estimates of the probability of default (PD) of sovereign exposures are not subject to the 0.03% floor, which applies to all other asset classes.</p>	<p>Same treatment as Basel, but “permanent partial use” as follows.</p> <p>CRR permits credit institutions using the IRB approach to apply the RSA to Member States’ sovereign exposures, irrespective of their size, as long as these exposures are assigned a 0% risk weight (Article 150 – “permanent partial use”). Conditions of partial use are much stricter under Basel, which permits IRB banks to use the RSA for certain exposures, as long as they are “immaterial in terms of size and perceived risk profile”.</p>
Market risk	<p>The Basel II market risk framework implies risk differentiation (not zero risk weight) through the capture of default risk (including sovereigns) in the trading book.</p>	<p>Same as Basel II.</p>
Liquidity Coverage Ratio	<p>No limits or haircuts are applied to domestic sovereign exposures that are eligible as high-quality liquid assets in meeting the liquidity standards</p> <p>While banks are required to diversify their HQLA within asset classes, this does not apply to the sovereign debt of the bank’s home jurisdiction or the jurisdiction in which the bank operates.</p>	<p>Same as Basel</p>
Large exposures		<p>Sovereign exposures are granted a full exemption from requirements limiting concentration risk in the EU, i.e. the large exposures framework</p>
Leverage ratio	<p>Sovereign exposures subject to the leverage ratio as all other exposures.</p>	<p>Same as Basel</p>

Source: EGOV

According to the [Basel Committee](#), on average, banks' risk weights for central government exposures under the internal ratings-based approach amount currently to 6.5%¹⁰. In the EU, findings of the EBA show that the risk weights calculated with EU banks' internal models led to a wide dispersion of results. According to the 2018 [EBA](#) credit risk benchmarking, sovereign exposures represent 36% of the total exposure value, but only 8% of the total risk-weighted assets. That led the [EBA](#) to consider that *"IRB models typically rely on a substantial amount of judgement and biases may consequently be introduced – for instance a reluctance to set high risk weights for domestic sovereign exposures"*.

While "domestic" sovereign exposures may not be risk-weighted, they are nevertheless subject to the leverage ratio, as all other exposures. The leverage ratio provides a "backstop" to sovereign risk exposures. This means that banks investing heavily in sovereign debt hold equity equal to at least 3% of their non-risk-weighted assets. In addition, as stated in a CEPR [note](#), *"the stress test exercises regularly conducted since 2011 have already de facto imposed positive risk weights on domestic sovereign exposures"* (See next sub-section).

Importantly, Basel III has removed the "prudential filter" that purported to reduce - under Basel II - the excessive volatility of regulatory capital related to changes in the fair value of banks' securities portfolio, including sovereign exposures. As emphasised by the ESRB, *"this prudential treatment of unrealised gains and losses in Basel III is, de facto, equivalent (from an economic point of view) to a capital charge"* for sovereign exposures, classified in the available-for sale portfolio (ESRB [report](#) on the regulatory treatment of sovereign exposures). That accounting treatment reflects the mark-to-market value of the assets in the capital positions of banks.

2.2 Stress tests of sovereign risks in the EU

At the peak of the sovereign crisis, the EBA included in the 2011 EU stress test a specific treatment for sovereign risk exposures. The stress test subjected sovereign exposures in the trading book to haircuts and developed a methodology based on probabilities of default provided by Credit Rating Agencies for sovereign exposures held in the banking book. In accordance with that methodology, *"the capital impact in the stress test for an exposure towards the Greek sovereign, for instance, was at least 17% of the nominal value of that exposure (...)"*. Retrospectively, those capital charges have proved well calibrated: *"One week after the results of the stress test were published, the ECOFIN Council agreed on private sector involvement (PSI) in the restructuring of Greece. As a result, banks had to agree to a 20% haircut of their exposure - not so far away from the EBA's preliminary estimates"* ("Sovereign Risk: Black Swans and White Elephants", Andrea Enria, Adam Farkas and Lars Jul Overby - [EBA](#)).

Since 2011, stress tests conducted by EBA have included sovereign risks as part of a constrained bottom-up approach (See Box 1).

As the [SSM](#) indicated its intention to develop a more "top-down" approach, the question remains as to how sovereign risk would be addressed in future stress tests. For background information, see EGOV [Briefing](#): "Towards a fundamental re-design of Banks' Stress Tests in the EU" (September 2019). In that regard, the ESRB recommended in its [report](#) on the regulatory treatment of sovereign exposures that *"Pillar 2 EU-wide supervisory guidelines (...) include explicit and direct recommendations to perform stress tests with the aim of assessing the risks and effects resulting from distress in sovereign exposures"*.

¹⁰ According to the [EBA](#) 2018 credit risk benchmarking exercise, risk-weights under the Foundation IRB approach are 2% and 7% under the Advanced IRB Approach (where both PD and LGD are estimated).

Box 1: Sovereign risk in EBA Stress tests

The EBA methodology for the EU-wide bank stress test in [2011](#) focused only on a part of all sovereign exposures held, namely those in the trading book. The trading book is designated to assets available for sale, which are then valued based on daily market information (marked-to-market). The EBA methodology applied haircuts and prescribed the method for calculating provisions for those exposures.

In the [2014](#) stress test, the methodology for recognising sovereign risk differed, depending on whether the exposures were held (i) in the regulatory banking book, (ii) as available for sale and designated at fair value in the profit and loss statement, or (iii) in the held-for-trading portfolio.

For sovereign positions in the regulatory banking book, banks were requested to estimate impairments/losses excluding fair value positions subject to the market-risk approach, in line with sovereign credit risk shocks provided by the ESRB/ECB. The other two categories were subject to the market risk parameters and haircuts provided for by the ESRB/ECB. Haircuts were applied to direct exposures, while other exposures were to be stressed with market risk parameters. Banks were also asked to compute stressed RWAs according to the applicable prudential framework and the corresponding credit risk or market risk approach.

From a methodological point of view, the [2016](#) stress test was overall quite similar to that of the 2014 exercise, though the sample of banks was significantly smaller than in 2014.

Sovereign risk was again part of the [2018](#) stress test methodology. Contrary to the 2014 and 2016 exercises, however, the EBA decided not to disclose the bank-by-bank results regarding sovereign exposures for that exercise, due to a change in the methodology; related information was only made available in the 2018 EU-wide transparency exercise.

2.3 Pillar 2

Supervisors can ask banks to hold additional capital or set qualitative restrictions if that is required in view of their individual risk profiles, as assessed in the Supervisory Review and Evaluation Process, or SREP for short (those measures are usually referred to as “Pillar 2”). Pillar 2 may therefore be used and has been used by supervisors to address excessive sovereign risk. Alongside the inclusion of sovereign risk as part of the 2011 EU stress tests, EBA recommended that national supervisory authorities (NSAs) required banks included in the sample (the largest EU banks) to strengthen their capital positions by building up an “exceptional and temporary capital buffer against sovereign debt exposures” (CET1 capital ratio of 9% by end June 2012).

In terms of going forward, the Chair of the SSM committed at [hearing](#) in the ECON Committee of March 2019 to taking supervisory measures in relation to banks’ holding of sovereign exposures: *“when I was at the EBA and there was an excessive problem of sovereign exposures at European banks, we took the responsibility of imposing a, what we called then, a buffer, a capital buffer under Pillar 2 to take care of these excessive risk. So this has been done in the past. That can be done in the future”*.

Currently, [EBA](#) guidelines on common procedures and methodologies for SREP and supervisory stress testing are rather silent on sovereign exposures. The [SSM](#) methodology does not seem to factor in sovereign risk. In contrast, the Basel Committee suggested in its [consultation paper](#) on the regulatory treatment of sovereign risk guidance (i) monitoring sovereign risk; (ii) stress testing for sovereign risk; and (iii) supervisory responses to mitigating sovereign risk. This includes e.g. the review of the adequacy of banks’ risk management system for monitoring and reporting sovereign exposures, assessment of banks’ stress testing, implementation of a satisfactory capital adequacy restoration plan, review of limits or reduction of sovereign exposures.

2.4 Pillar 3

[EBA](#) has already significantly enhanced the disclosure of sovereign exposure, drawing on the lessons gained in the sovereign crisis where *“opaqueness of risk exposures and uncertainty on valuation criteria have been a powerful crisis accelerator”*. As part of the stress test results in July 2011, sovereign holdings were disclosed

in details. [EBA](#) “Transparency exercises” also provide a clear picture of banks’ exposure and in particular exposures of banks’ home country (See Section 1 for the latest data). That disclosure framework is nevertheless limited in scope (a limited sample of EU banks) and is carried out on a voluntary basis and without a robust legal underpinning. Against that background, [EBA](#) has recommended a mandatory disclosure framework for banks’ sovereign holdings. Likewise, the Basel Committee suggested disclosure requirements related to banks’ exposures and risk-weighted assets of different sovereign entities by jurisdictional breakdown, currency breakdown and accounting classification.

3. Which options for a Regulatory Treatment of Sovereign Exposures?

Different options and approaches to regulating sovereign exposures have been discussed in the past. This section provides an overview of possible treatments suggested, as possible options, by EBA¹¹, the Basel Committee¹², the ESM¹³ and the ESRB¹⁴. Those options are summarised in Table 2. None of these options have reached consensus, which led the [Commission](#) to consider in its impact assessment of Sovereign Bond-Backed Securities that a ‘no RTSE change’ scenario is in line with the conclusion of the discussion at international level¹⁵.

3.1 Focus on credit risk

In terms of going forward, options set out in Basel Committee’s [consultation paper](#) on the regulatory treatment of sovereign included the (i) the removal of the internal ratings-based (IRB) approach framework for sovereign exposures; (ii) revised standardised risk weights for sovereign exposures held in both the banking and trading book, including the removal of the national discretion to apply a preferential risk weight for certain sovereign exposures. In the same vein, [EBA](#) considered that a “*low, non-zero, risk weights would force banks to more actively manage the risk in their sovereign exposures*”. The impact of similar options has been assessed by the ESRB (See Table 2). That approach has been criticised by a recent discussion paper published by the [ESM](#), given the potential risks to financial stability that regulatory approach would entail (See Table 2).

3.2 Focus on concentration risk

Other options discussed by the Basel Committee included the introduction of a “*marginal risk weight additions that would vary based on the degree of a bank’s concentration to a sovereign (defined as the proportion of sovereign exposures relative to Tier 1 capital)*”. That prudential treatment would aim at mitigating the potential risks of excessive holdings of sovereign exposures. In a [paper](#) commissioned by the ECON Committee¹⁶, the following design and calibration of a “Sovereign Concentration Charge” has been suggested. That concentration charge “*would add sovereign exposures above a certain threshold (defined as a ratio to Tier-1 capital), weighted by a coefficient (sovereign concentration charge) that increases with the exposure ratio, to risk-weighted assets in the capital ratio’s denominator. The charges for concentrated sovereign exposures to different euro-area countries would add up*”. If sovereign concentration charges were applied on a country-by-country basis, they would in particular disincentivise the problematic accumulation of single name default risks, and give an incentive to hold bonds from not only one but many issuers. In terms of calibration, it was suggested to exempt sovereign exposures under 33% of Tier 1 capital, to avoid risks of disturbance in sovereign debt market.

¹¹ Views expressed in “Sovereign Risk: Black Swans and White Elephants” (Andrea Enria, Adam Farkas and Lars Jul Overby - [EBA](#)).

¹² “Potential ideas related to the regulatory treatment of sovereign exposures” identified by the Basel Committee’s [consultation paper](#) on the regulatory treatment of sovereign risk, December 2017.

¹³ Views expressed in “Completing banking union to support Economic and Monetary Union”, ESM, October 2019.

¹⁴ ESRB [report](#) on the regulatory treatment of sovereign exposures, March 2015.

¹⁵ In its December 2017 [Discussion Paper](#) on “The regulatory treatment of sovereign exposures”, the Basel Committee noted that it “has not reached a consensus to make any changes to the treatment of sovereign exposures, and has therefore decided not to consult on the ideas presented in this paper”.

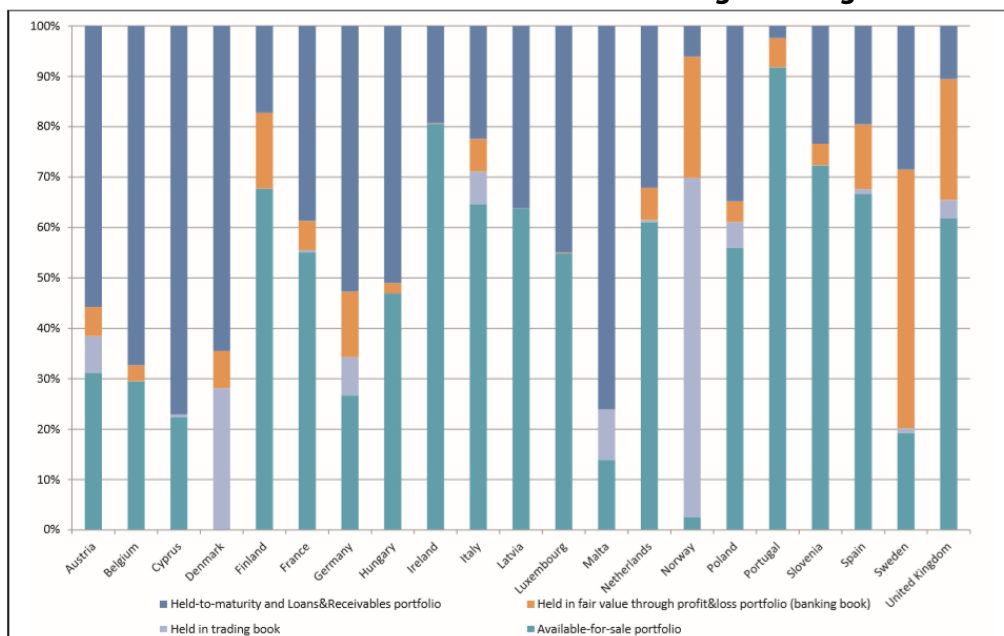
¹⁶ N. Véron, « Sovereign Concentration Charges: A new Regime for Banks’ Sovereign Exposures », November 2017.

That approach has met with some criticism. In particular, it has been noted that a concentration charge would conflict with liquidity requirements: *“it would not allow banks to meet the LCR by using sovereign bonds, which are the only ‘very’ liquid financial instrument”*¹⁷. The definition of liquid assets under the LCR has been nevertheless questioned, as sovereign exposure may prove illiquid (See next sub-section).

3.3 Valuation of liquid assets under the Liquidity Coverage Ratio (LCR)

The EBA Transparency Exercise in 2015 documented a wide diversity in practices across banks and Member States (See Chart 3). At that time, large parts of sovereign exposures were recorded in banks’ accounts at amortised cost (based on historical acquisition values), not recorded at fair value (reflecting the current market situation). As explained by the [EBA](#), *“this implies that swings in market prices are not reflected in the bank balance sheets and in measures of capital adequacy. Should a bank need to dispose some of its sovereign holdings during a phase of falling prices, in order to for instance address a short-term liquidity stress, regulatory capital would not have been set aside to absorb these losses”*.

Chart 3 - Valuation methods used for sovereign holdings¹⁸



Source: EBA 2019 Transparency Exercise according to [Enria, Farkas, Overby \(2016\)](#): “Sovereign Risk: Black Swans and White Elephants”, in European Economy Banks, Regulation, and the Real Sector 2016.1, sample of the EBA Transparency exercise

It seems inappropriate to use the amortised cost approach for sovereign exposures, in particular if they are meant to fulfil the requirements of the LCR, measuring how many highly liquid assets are available to meet short-term obligations; in case of need, they will have to be quickly sold on the financial markets, and for that purpose the information provided by a fair value measurement is much more relevant. This has led the [EBA](#) to recommend that *“sovereign assets used to fulfil the LCR requirements should always be measured at fair value, also for accounting purposes”*. This approach may need to be coupled with a *“requirement to include a significant portion of the sovereign portfolio in accounting books that entail mark-to-market valuations”*. As [EBA](#) put it, *“a greater reliance on mark-to-market valuations would provide a powerful incentive for banks to actively manage sovereign risk, while also addressing concerns that were the exclusive focus of market participants during periods of stress”*.

¹⁷See “Recent developments in the regulatory treatment of sovereign exposures”, M. Lanotte and P. Tommasino, Vox CEPR Policy Portal note, February 2018

¹⁸ Measure used is net direct holdings according to accounting classification. More specifically, according to IAS 39, financial securities have to be classified into four categories: i) Financial assets at fair value through profit or loss (FVPL) - this category relies on fair value and has two sub-categories, which are used in the above chart, which are respectively Held for Trading (HfT) and Fair Value Option (FVO), 2) Available-for-sale financial assets (AFS) - this category relies on fair value, 3) Held-to-maturity investments (HtM) - this category relies on amortised cost and 4) Loans and receivables (L&R), which relies on amortised cost.

It is not clear whether the wide diversity in accounting practices for sovereign exposures documented in the EBA Transparency Exercise of 2015 is still the case. In January 2018, a new accounting standard (IFRS 9) came into force; it is generally based on the concept that financial assets should be classified and measured at fair value, unless restrictive criteria are met for classifying and measuring it otherwise. It would therefore be interesting to see an updated graph by EBA on the current valuation methods used for sovereign holdings.

Table 2 - Proposals or options for a RTSE

	EBA proposal	ESM paper	Basel Committee	ESRB
Risk weights	Low but positive risk-weights should be introduced for domestic exposures	“A longer-run negative effect on profitability” “Positive risk weights could even have a pro-cyclical effect enforcing market tensions at times of crisis” “The potential divergence of sovereign funding costs entails a financial stability risk”	“Removal of IRB approach for sovereign exposures”. “Positive standardised risk weights for sovereign exposures”. “Removal of national discretion to apply a preferential risk weight for domestic central government exposures”	Options includes (i) introducing a non-zero risk-weight floor in the RSA; (ii) setting a minimum floor in the IRB approach The ESRB did not recommend doing away with the IRB approach, which provides a more granular assessment
Concentration risk	“Capital requirements increasing with concentration risks, according to a metric compatible with the liquidity requirements”	“Concentration-focused measures seem preferable as they would avoid undermining the competitiveness of European banks” (as opposed to risk-weights)	Introduction of marginal risk weight add-ons to mitigate concentration risk for sovereign exposures	Options include: (i) removing the exemption of sovereign exposures from large exposure limits (with risk-sensitive limits); (ii) introducing a capital requirement for concentration risk
Macro-prudential Regulation	Capital buffer against sovereign risks recommended in 2011 by EBA			Through-the-cycle sovereign risk weights, using indicators.
Accounting treatment and Liquidity Coverage Ratio	“Requirement to include a significant portion of the sovereign portfolio in accounting books that entail mark-to-market valuations”	“This benefit carries some risks. Banks’ balance sheets would become more volatile while market volatility in sovereign securities prices might be highly unpredictable”		Options include market indicator of liquidity for the purpose of defining liquid assets and haircuts differentiated according to actual market liquidity
Contribution to EDIS		“Sovereign risk could be reflected in banks’ contribution to EDIS”.		
Pillar 2			Guidance on monitoring, stress testing and supervisory responses	Stress test methodology on sovereign risk and Pillar 2 guidance on top of a pillar 1 treatment
Pillar 3	Mandatory disclosure framework for banks’ sovereign holding		Disclosures of sovereign exposures and risk weighted assets by jurisdiction, currency denomination and accounting classification	Specific mandatory template on sovereign risk disclosure

Source: EGOV

4. Should a regulatory treatment of sovereign exposure be proposed in isolation or coupled with other regulatory or institutional developments?

As the Chair of the High Level Working Group on EDIS (HLWG) put it, “*progress will be needed in all areas and therefore a comprehensive approach building on a package of measures is needed*”. In that respect, the completion of the Banking Union would certainly need a comprehensive roadmap including a RTSE, EDIS and a European safe asset, where appropriate. For further background information, see EGOV [Briefing “Banking Union: what next”](#) (July 2019).

4.1 Debate at the Eurogroup

Debates at the Eurogroup have come up against the very concept of a RTSE, the adequate sequencing of reforms and whether a RTSE should be coupled with a European safe asset. While some Ministers condition EDIS to a regulatory treatment of sovereign exposures, others are of the view that a RTSE should only be “looked at”, should sufficient progress be achieved on other “risk-sharing” elements of the Banking Union. Some Member States remain reluctant to contemplate a RTSE. That debate has been summarised by the Chair of Eurogroup’s High Level Working Group on EDIS in June 2019 as follows (See Box 2).

Box 2: Sovereign risk and financial stability, as discussed at the High Level Working Group on EDIS (HLWG)

(...) Several members consider that there should be a revision of the regulatory treatment of sovereign exposures (RTSE) to incentivize banks to diversify their holdings of sovereign debt, while other members are open to looking into the various options for RTSE, linked to sufficient progress on other measures. These members agree that further analytical work is needed before deciding and that measures should be appropriately timed, carefully designed and gradually implemented. Different options exist in this respect, ranging from risk-based contributions to EDIS, valuation measures, concentration based measures, risk based concentration charges, to credit risk based measures. Other members remain opposed to any changes to the RTSE, arguing that such changes could undermine the functioning of sovereign bond markets while not addressing the indirect feedback loop between banks and national sovereigns which derives from the relationship between banks and their wider national economic environment.

Views on sequencing with other measures also still differ. For many members, the opening of the discussion on RTSE is linked to progress on other files of the Banking Union or to international developments. For some members the implementation of RTSE should go hand in hand with the introduction of a new European safe asset in order to cater for any unintended financial stability consequences. Some highlight that is too early to make this connection, especially as there is no agreement on what could constitute a European safe asset for this purpose. Others argue that a distinction should be made between a safe asset which leads to a mutualisation of public debt and one that does not, including both public and private initiatives. They consider the first option to be closely related to the discussion on a Fiscal Union and underline that safe assets are not part of the 2016 Council Roadmap”.

4.2 EDIS and RTSE

In a recent discussion paper, the [ESM](#) outlined a stepwise approach to completing the Banking Union, suggesting as a step 3 (after 2027), that “*the Member States could approve the implementation of stage 3 of EDIS which foresees full mutualisation [and] implementation of a scheme to diversify sovereign exposures*”. This approach echoes what a [study](#) commissioned by the ECON Committee¹⁹ suggested as a *quid pro quo*. For Nicolas Véron, “*The home-bias problem, in turn, is a key obstacle to the adoption of a European Deposit Insurance Scheme (EDIS), as proposed by the European Commission in late 2015, because of the suspicion that deposits protected by EDIS would be used by banks, under moral suasion from their home country’s government, to excessively increase their purchases of that government’s debt. In turn, the absence of a full EDIS is one of the*

¹⁹ N. Véron, « Sovereign Concentration Charges: A new Regime for Banks’ Sovereign Exposures », November 2017.

banking union's greatest weaknesses because deposits are not protected uniformly. There is therefore a strong policy case for the simultaneous consideration of EDIS and of a regulatory instrument targeted at reducing highly concentrated sovereign exposures. The adoption of one of these two reforms without the other is both unlikely and arguably undesirable".

In contrast, while calling for a cautious and progressive approach, [EBA](#) and [ESRB](#) suggested introducing a RTSE for its own merits, given the risks banks are exposed to.

4.3 Safe assets and RTSE

The Commission's October 2017 Banking Union [communication](#) explicitly linked the development of Sovereign bond-backed securities (SBBS) - a new financial instrument proposed by the Commission that aims to support a portfolio diversification in the EU banking sector - to the broader debate of the sovereign risks treatment: *"In order to make tangible progress on this matter [i.e. regulatory treatment of sovereign bonds], SBBS could as a first step have the potential to contribute to the completion of the Banking Union and the enhancement of the Capital Markets Union".* Put another way, as emphasised in the 2011 SBBS [paper](#), changing the RTSE *"would only be fully effective without creating problems of its own if banks had an alternative safe asset to hold"*. For further information on SBBS, see EGOV [Briefing](#): *"Are Sovereign Bond-Backed Securities ('SBBS') a 'self-standing' proposal to address the sovereign bank nexus"?*

The SBBS proposal has met with strong resistance in the Council, which does not seem willing to make progress on the Commission's legislative proposal. For other safe assets proposals, it must be noted that *"Moving towards a common safe asset seems (...) only possible with the necessary underlying governance structure, that is a fiscal policy coordination framework enforcing the commonly agreed budgetary stance"* ([ESM](#), *"Completing banking union to support EMU"*).

Other authors have considered that RTSE does not necessarily need to be coupled with a safe asset. As explained in Véron's [paper](#), a sovereign concentration charge *"entails neither forced buying of any sovereign securities, nor any supranational guarantee. [It] would incentivise banks to diversify their sovereign bond portfolios, but it is not at all prescriptive as to which bonds to buy (if any). Thus, [a sovereign concentration charge] achieves the portfolio-diversification aims inherent in several safe asset designs, but in a manner that is 'light-touch' and market-driven, compared with other proposals"*.

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Contact: egov@ep.europa.eu

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