Institutions

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The regulation on sovereign exposures: The Basel framework and the European Directive

The main framework of recommendations of the Basel Committee on Banking Supervision (BCBS) on risk weights for sovereign exposures is still that of Basel II (BIS, 2006). According to this framework, banks may choose two ways of assessing the risk of an exposure depending on the methodology used: (i) the standardized form or (ii) the internal-rating based (IRB) approach.

The Basel II framework allows banks to apply a weighting rage between 0 per cent and 150 per cent when an assessment from a rating agency is available. Table 1 displays the weights applied to sovereign debt depending on credit rating assessments under the Basel II standardized approach.

Table 1 - Basel II standardized approach: Sovereign risk weights (in percentage)

Credit ratings	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weights	0	20	50	100	150	100

Source: BIS (2013).

Banks opting for the IRB approach are instead allowed to use their own internal measures of credit risk by using a granular rating scale, accounting for all relevant differences in risk with an adapted risk weight per sovereign (EBA, 2015).

However, paragraphs 53 and 54 of the Basel II Accord state that “at national discretion, a lower risk weight may be applied to banks’ exposures to their sovereigns (or central banks) of incorporation denominated in domestic currency and funded”.

In fact, the European Capital Requirement Directive - Directive 2013/36/EU (CRD-IV), and Regulation (EU) No. 575/2013 (CRR) - introduced a more general zero risk weight, that can be seen as an extension of the provisions of Basel II: a zero risk weight is assigned to all “exposures to Member States’ central government” denominated in the domestic currency. For Eurozone member countries, this implies that all sovereign exposures denominated in euros have a zero risk weight.

Under the new Basel standards domestic and 0 per cent risk-weighted government bonds are explicitly exempted from the limits on large exposures (ESRB, 2015).[9]

Basel III (BIS, 2014) has not modified the main framework on risk weights and large exposures on sovereigns of Basel II, but it has introduced three main additional requirements impacting on holdings of government debt: the leverage ratio, the liquidity coverage ratio (LCR), and the net stable funding ratio (NSFR).

The leverage ratio is defined as the ratio of capital (usually CET1 or total regulatory capital) to risk exposures. Since sovereign exposures are included among total risk exposures, the denominator of the leverage ratio, even a bank investing only in sovereign debt would be forced to hold equity of at least 3 per cent out its assets. More in general, the leverage ratio will work as constraint on sovereign holdings for banks that operate close to the minimum regulatory level (or close to a target internally set).[10]

Under Basel III, sovereign bonds with a zero risk weight are considered highly liquid assets both for the purpose of respecting the LCR and the NSFR. Altering the risk weighting of sovereign bonds might have a sizeable impact on banks’ abilities to respect these ratios.

Recently, the Five President’s report (EPSC, 2015) and a more recent document produced under the Dutch Presidency (AHWP, 2016) suggest that

9. Article 400 of the CRR exempts all sovereign exposures that would be assigned a risk weight of 0 per cent under the standardised approach for credit risk from the limit to large exposures.

10. Liquidity is measured under Basel III through the liquidity coverage ratio and the net stable funding ratio. The liquidity coverage ratio entered into force on the 1st January 2015, although the minimum requirement began at 60 per cent, raising an equal step of 10 percentage points to reach 100 per cent will began on the 1st January 2019. The NSFR will be enforced from the 1st January 2018.

the zero risk weight and large exposures allowances on sovereign debt within the European union should be reconsidered, on the grounds that they may be a source of vulnerability.

The Five Presidents' Report (2015) report propose to review the treatment of large exposures to sovereign debt in the medium term. However, far-reaching changes to the current framework should only be considered as part of a coordinated effort at the global level. The Basel Committee has not decided on these models yet, but plans to make a decision on the new regulations in 2016.

The regulation on sovereign exposures in other countries

In the **United Kingdom**, the Basel framework and the Capital Requirement Directives are integrated in the national legislation. The Prudential Regulation Authority (PRA) Rulebook Online stablishes the exemption of large exposures to sovereign debt in respect of Article 400 of the CRR.

Interestingly, in **Sweden,** the Financial Supervisory Authority announced, in October 2015, that it would require its four largest banks to apply positive risk weights on their sovereign exposure (Lenarcic et al., 2016).

In **the US**, according to the Dodd-Frank Wall Street Reform and Consumer Protection of 2010, government exposures, including securities issued by the Federal Reserve and the federal government agencies, are assigned a zero risk weight (Getter, 2015). Exposures to foreign governments (and banks) are assigned risk weights depending on whether the entity is a member of the Organization for Economic Co-operation and development (OECD hereafter) and if the country has received Country Risk Classification (CRC hereafter) assigned by the OECD. The Federal reserve Banks and the Federal Deposit Insurance Company launched the final rule 12 CFR § 208.225 in order to introduce specific risk-weighting factors for sovereign debt position. This rule, which entered into force on April 1st 2014, maps the risk weights to CRCs in a manner consistent with the Basel II standardized approach and contains specific provisions depending on whether the position is denominated in the sovereign entity's currency, the bank has at least an equivalent amount of liabilities in that foreign currency, and the sovereign entity allows bank under its jurisdiction to assign the lower specific risk-weighting factor to the same exposures to the sovereign entity.

Finally, in **Japan**, the Basel II regulatory framework is integrated within the national legislation. Regarding Basel III, the new regulatory capital requirements are fully implemented, although other requirements such as the leverage ratio are still phasing-in. The Japanese Government Bonds (JGBs hereafter) are assigned zero risk weight, in line with the current Basel approach.

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