‘How much of bank credit risk is sovereign risk?’ – J. Li and G. Zinna

Discussion by M. Rimarchi* – 3rd EBA Policy Research Workshop – November 2014
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* Opinions expressed here are personal and do not reflect those of the EBA

Li and Zinna exercise in 2 slides (1/2)

1) The paper investigates **<u>the topic</u>** of the ongoing post-crisis policy and regulatory debate: **the nexus between sovereign credit risk and bank credit risk**

2) It measures sovereign and bank credit risk as priced-in within available CDS spreads: 4 sovereigns (2 Core Euro: DE – FR & 2 Peripheral: IT – ES) and 21 banks equally split / time horizon: 2008-2013

3) It combines two different reduced-form credit risk models in a **2-stage (bayesian) estimation**:

   Stage 1: Sovereign Default = f (systemic shock, country-specific shock)

   Stage 2: Bank Default f = f (systemic shock, country-specific shock, bank-specific shock)

4) Methodology (3) allows:

   I. Disentangling the role of systemic sovereign (e.g. euro break-up) Vs country-specific sovereign risk in the market pricing of both sovereign credit risk and individual banks' credit risk – Ranking exercise with respect to Germany (the norm)

   II. Investigating relevant determinants of estimated systemic sovereign & country-specific sovereign exposures bank's exposures – Policy Implications?

Li and Zinna exercise in 2 slides (2/2)

What do we learn from the main exercise? The paper seems to support anecdotal evidence we are aware of…

1) The systemic sovereign component, as priced-in by the markets, responds to 'exogenous' announcements – e.g. Euro and US Central Banks extraordinary operations / IMF-EU country programs / Fiscal measures in the periphery etc.;
2) November 2011 marks the sample peak of systemic sovereign 'panic' in the Euro area;
3) Domestic sovereign risk is more relevant to bank risk in the periphery than in the core Euro area – i.e. Germany has almost no idiosyncratic risk;
4) DE and FR banks have invested in peripheral assets, enhancing their exposure to systemic sovereign exposure;
5) **Policy focus: 'exposure to sovereign risk increases with..'**
   a) **Bank size;**
   b) **Holdings of debt securities** /non-domestic → systemic risk / domestic → country risk;
   c) **Sovereign Subsidy:** zero risk weight on Euro area sovereign securities;
   d) **Implicit government support** (rating uplift) → country risk.

My general comments

- The paper is very rich in terms of results – however at times also rich in allowing for various ways of reading/explaining the results or linking results to events …

    e.g.

    In the event of a country shock:

    DE and FR banks have higher probability of default than DE and FR sovereigns: **country ceiling and/or investment in peripheral gov. bonds?**

    IT and ES banks have lower probability of default than IT and ES sovereigns:

    why?

- The partition of core (DE, FR) Vs periphery (IT, ES) Euro area is somehow in the paper even if explaining the clustering in light of the results is not always easy…

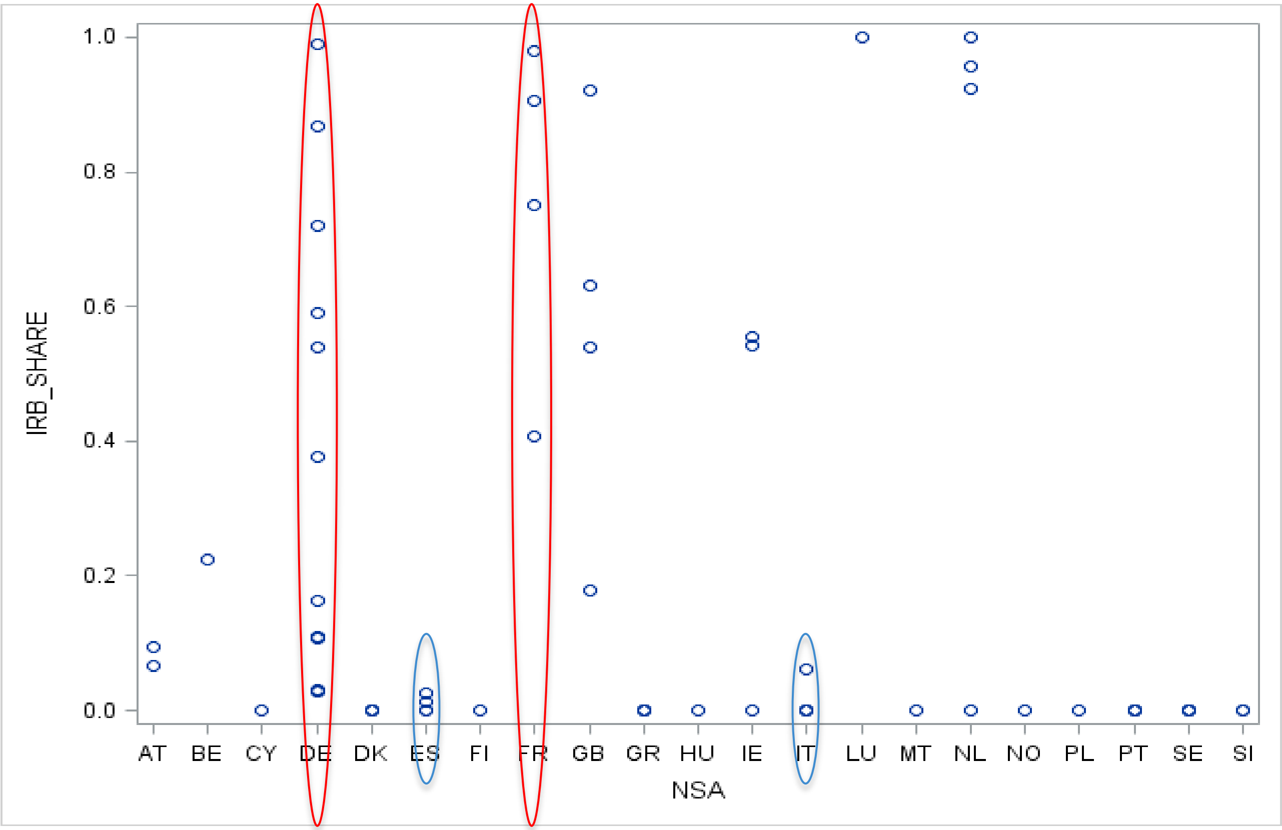
The paper is food for thought for the policy/regulatory debate 1/2

Whether they impact on CIW or SIW, the determinants of sovereign risk within bank credit risk need be addressed by policy/regulation by acting on banks' incentives to hold government debt

- Standardised Approach zero-risk weight on domestic sovereign bonds & on AAA/AA non-domestic sovereign bonds: *at Basel level treatment of sovereign exposures is under review*
- Permanent/Partial use of IRB models on (inter alia) sovereign exposures : *EBA proposes a 8% of total exposure value maximum amount for part of the exemptions / remaining exemptions to be addressed under 2018 Guidelines*
- In IRB approach PD floor of 0.03% does not apply to Sovereigns: *EBA uses non-zero PDs for AAA/AA rated sovereigns within its stress tests methodology*
- Liquidity regulation: *under the Commission LCR delegated act covered bonds make it to Level 1 assets – under some conditions posing a diversification alternative to gov bonds*
- The EU large exposure framework still does count highly rated sovereigns from the 25% of equity limit on large exposures

As well as on the institutional framework: under the BRRD framework implicit support of a given sovereign is (potentially) out of the game…

The paper is food for thought for the policy/regulatory debate 2/2



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