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FIG in Focus

Welcome to the first edition of our regular briefing on news and views in the FIG (financial institution group) world.

We are financial institution group geeks and so we find all this risk, regulatory and performance information interesting.

If you opened this, hoping to find out more about delicious Mediterranean fruit… please drop us a line and we will remove you from the mailing list.

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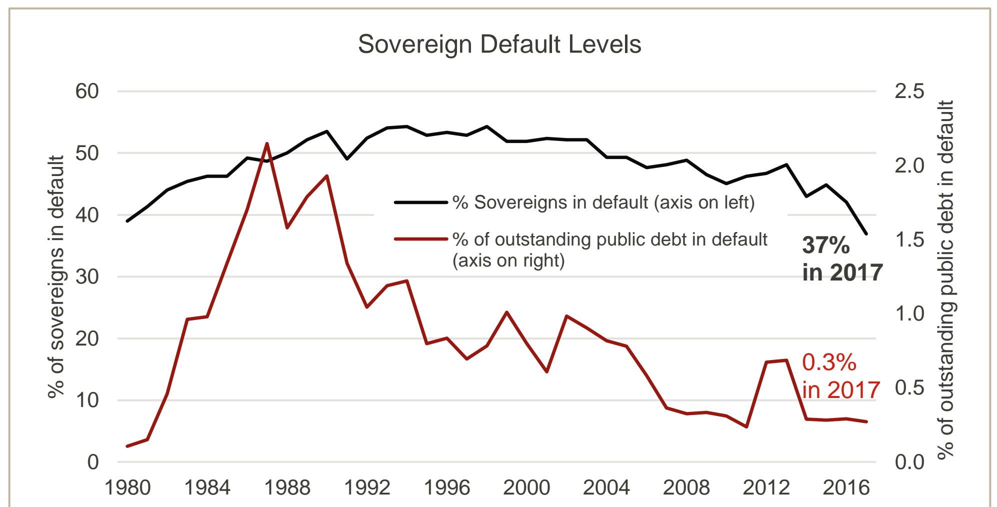
Risk – Sovereign Exposures

Sovereign exposures risk weighted at zero for bank and insurer standardized approaches? Who are we kidding?

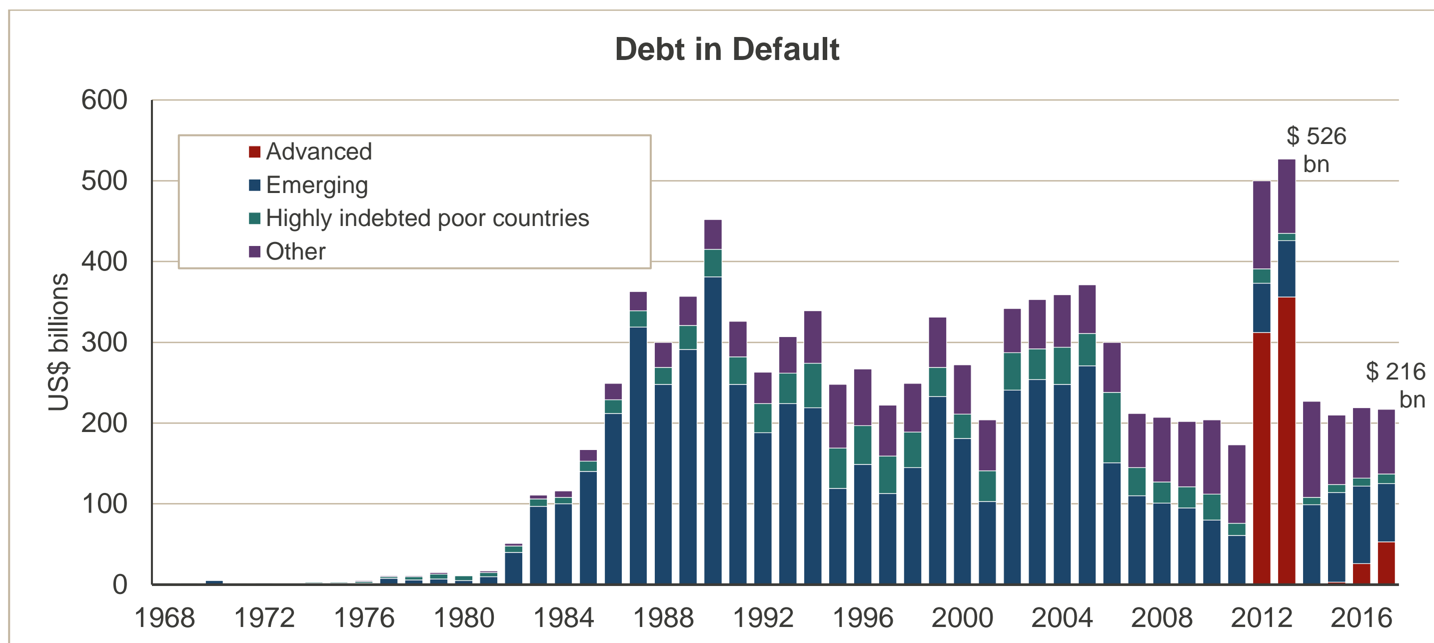
The Bank of England and Bank of Canada have recently published a fantastic summary of sovereign defaults.

We were struck by 31 defaults on local currency since 1960 and the fact that 145 different governments have defaulted in some way in the data shown. This is more than half of the countries in the data base.

As the graph here shows 37% of sovereigns were in some form of default in 2017 although this only amounted to 0.3% of outstanding sovereign debt.



Source: Bank of Canada CRAGS database 2018



Source: Bank of Canada CRAGS database 2018

The fact that banks and insurers are allowed to risk weight at zero is often justified on risk grounds, as follows:

- Credit default risk is low as long as the debt is local currency: most sovereigns can print their own money and so can theoretically repay all debt through inflationary measures. This is belied by the high number of 31 local currency defaults in the data. A further counter-argument to this is the high number of countries (particularly in the Eurozone) who cannot print their own money.
- Credit spread risk: investors are vulnerable to a fall in the value of government bonds if spreads widen. In theory, this is OK as long as the investors hold the bonds to maturity but in practice liquidity requirements (especially in banks) mean bonds may be sold early crystallizing losses. Moreover, the valuation losses feed through to falls in reported solvency and so present an on-going risk.
- Interest rate risk: interest rate risk is very significant for both banks and insurers and very difficult to manage and measure particularly for insurers with long duration liabilities. Both Basel II and Solvency I gave institutions a free ride on this and although Basel III (through pillar II) and Solvency II address interest rate risk, the transition measures are long and implementation mixed.

The rationale for the zero weight is largely political:

- Who else is going to invest reliably in risky sovereign debt?
- Higher risk weights would lead to capital shortfalls and negative economic consequences

A further problem with sovereign exposures is that concentration guidelines are waived so that institutions may end up with substantially more than 25% of their capital exposed to a single sovereign issuer. Some regulators are pushing for change on this but expect it to be slow. We analysts need to adjust for this by adjusting reported capital and applying notional risk weights to the zero weighted sovereign bonds.

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Regulatory – Principles of Liquidity Risk Management

In January 2019 the Basel Committee on Banking Supervision completed a review of its 2008 “Principles for sound liquidity risk management and supervision”. Based upon a review of liquidity risk management standards in the 28 Basel member countries, the key findings of the review were:

- All member committee jurisdictions have implemented the 2008 principles through either regulation, guidance or supervisory practice.
- The Basel III ratios (LCR and NSFR) are important complementary measures to the standards but cannot be a substitute the broader remit of the seventeen principles. The principle should therefore remain an important part of supervisory policy.
- Post-2008 market developments such as derivatives clearing and increased digitisation of payment systems have significantly increased the potential velocity of liquidity risk.

The study concluded that despite changes in both the regulatory and market environment over the decade since the principles were first issued, they remain a key reference point for the framing of supervisory policy and bank liquidity risk management frameworks.

The 2008 Basel Risk Management Principles may be viewed here: https://www.bis.org/publ/bcbs144.htm

Performance – Are banks too liquid nowadays?

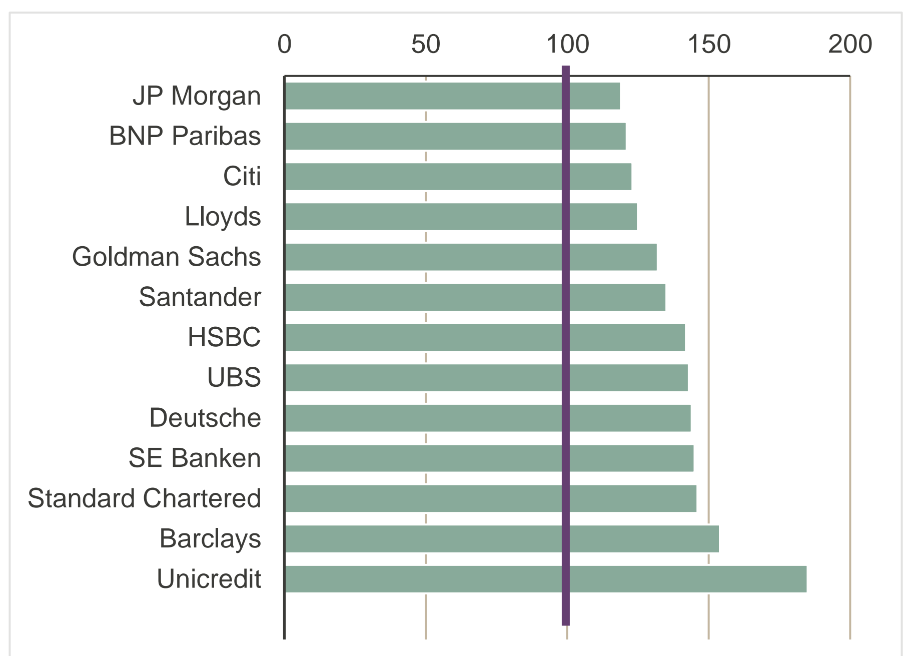
Basel III stipulated that banks have to hold sufficient high-quality liquid assets (HQLA) to cover potential outflows in a stress situation lasting 30 days. The assumptions are quite conservative, for example:

- High quality liquid assets must be *primarily* composed of only the most liquid assets e.g. cash and top-rated Government bonds
- More than 25% of corporate deposits < 30 days and 100% of institutional deposits will disappear
- Derivative liabilities will incur substantial margin calls

As banks earn so little on their liquid assets, you would expect them to want to minimise the amount they hold especially as most regulators have indicated they would be allowed to operate with a ratio below 100% during a stress situation.

However most large European banks are holding well in excess of the minimum requirements. Buffers over required capital levels are much lower at 10%-20%.

(Source: Banks’ annual reports 2017)



There are several reasons that banks may be holding so much liquidity. Here are a few:

1. Banks have conservative liquidity risk appetites and want to keep a buffer over both the minimum regulatory requirement and whatever they use in their internal measures.
2. Certain regulators may be requiring higher levels as part of Pillar II supervisory review.
3. Some banks are sitting on substantial deposit balances but do not see attractive lending opportunities in today's market.
4. Banks have excess liquidity but are still a little capital constrained and so prefer to hold low or zero weighted assets.
5. In some countries there may be a positive carry between deposits and sovereign bonds.

Interesting links

Global finance from McKinsey. Great balance of retrospective and forward-looking analysis.

https://www.mckinsey.com/industries/financial-services/our-insights/a-decade-after-the-global-financial-crisis-what-has-and-hasnt-changed?cid=soc-web

The ECB's Financial Stability Report for November highlighted the significant widening in Bank Spreads in October/November This is particularly evident for AT1 and Senior "bail-in" Bonds. Whilst part of this widening undoubtedly represents idiosyncratic risks, is the cost of contingent capital telling us something about the likelihood of a systemic downturn?

https://www.linkedin.com/feed/update/urn:li:activity:6477910481699897344

Article by Adeva's Sarah de Quant: If it is a venial sin for a bank to pay too much for its money, it is a mortal sin for the bank not have funding at all.

https://www.linkedin.com/pulse/venial-rather-than-mortal-sin-unicredit-sarah-de-quant/

What yield would you need to buy Monte dei Paschi sub debt? 11% would not do it for us but some of you may be tempted! This FT article highlights the funding and capital challenge of weaker banks as investors wake up to the fact that BRRD is real.

https://www.ft.com/content/6d3c6a3c-d2ac-11e8-a9f2-7574db66bcd5

FIG JAM… just ask me!

We had to get that pun in somewhere! We love to get questions during our classroom sessions or during online digital learning. Please do contact us at figinfocus@adevapartners.com with any questions or suggestions for future articles or commentary.