FIG in Focus

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Sovereign Debt

Welcome to FIG in Focus, a collection of Insight pieces focusing on the Financial Institutions Group world from Adeva Partners.

This month we are focusing on sovereign debt, whilst looking at the question of whether domestic sovereign bonds should be risk weighted. In this article, we will explore how we should assess asset quality and capital adequacy for banks in those countries with sub-investment grade ratings.

What we will cover:

- Bank's risk weighting methodology applied to sovereign debt exposures
- Case Study: Lebanon 'a reminder of how risky sovereigns can be'

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How risky is sovereign debt?

Sovereigns issue debt in both local and foreign currency (most typically US$). Debt in local currency is typically considered "risk free" in the domestic market, as the government notionally has the ability to repay the debt by creating or "printing" its own currency, raising taxes or cutting expenditure.

History has shown us that such exposures are not risk free; examples of default on local currency debt include Venezuela (1998), Russia (1998), Ukraine (1998), Ecuador (1999), Argentina (2001) and Jamaica (2010 and 2013). When put in an untenable position, governments have chosen at times to default rather than pursue politically unpopular measures.

Should sovereign bonds be risk weighted?

This question has been circulating for ages. Those who say no, use the above to argue that there is no risk of default on sovereign bonds denominated in local currency. But what about foreign currency denominated government securities? As an analyst assessing the credit standing of a bank, how should we assess asset quality and therefore capital adequacy for banks operating in countries with low, sub-investment grade ratings?

The chart below shows the current standardised approach for risk weighting exposures to sovereigns and central banks. Since local regulators can decide how this is used, most banks risk weight their own sovereign exposures at 0%, independent of the rating. Basel IV proposes that there is a distinction between the domestic and foreign currency bonds.

Current standardised approach look-up table for exposures to sovereigns and central bank

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%

Basel suggests rating based risk weights for sovereign bonds but this is usually ignored for the domestic sovereign. Analysts can easily adjust for this and certainly should on the foreign currency bonds.

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Case Study: Lebanon

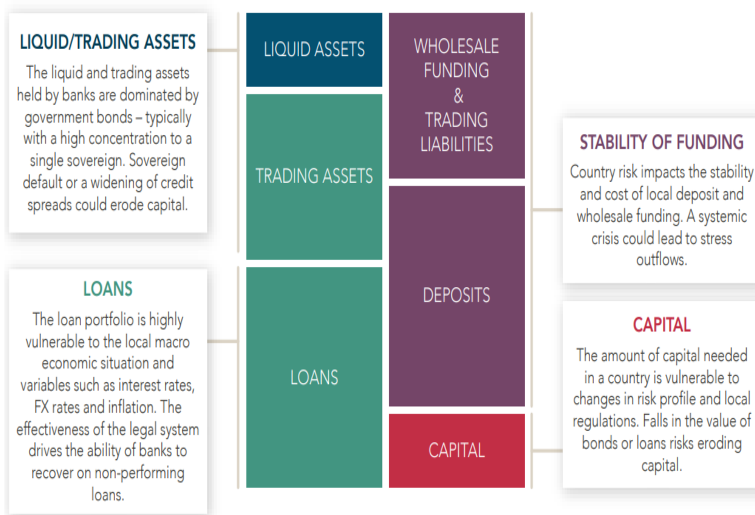
Lebanon is a reminder to us all how risky sovereigns can be. On 9 March 2020, the country defaulted on it foreign currency obligations and is likely to have to restructure domestic currency debt.

As Lebanon spiralled into financial disarray in 2019, the central bank partially addressed the risk on its foreign currency bonds. On 18 September 2019, Banque du Liban (Bdl) increased the risk weight of Lebanese Sovereign US$ Eurobonds to 150%, although the risk weight on BdL deposit placements in foreign currencies remained unchanged at 50%. (S&P sovereign rating was B- at that time but lowered to CCC November 2019.)

On 3 February 2020, BdL increased the regulatory expected credit losses on foreign currency exposures to Lebanese Sovereign and Central Bank of Lebanon, and exposures to resident corporates, retail and SMEs. In addition, the change in regulation tripled risk weights on US dollar exposures with the BdL of more than one year from 50% to 150%. To avoid the additional systemic risk that a capital breach could cause, the minimum capital ratios were lowered to 7.0% for CET1 and 10.5% for total capital ratios, in alignment with the Basel minima.

On 4 September 2020, BDL issued a circular stating: Banks and financial institutions operating in Lebanon must apply a statutory Expected Credit Loss (ECL) of 1.89% on foreign currency placements with the Central Bank (including certificate of deposits) and 45% on foreign currency placements with the Government. The provisions of the circular, however, do not require the constitution of any statutory ECL on local currency placements with the government or with the central bank, despite the expectation that these may not be serviced. These provisions will be constituted progressively over a period of five years, noting that the BDL Central Council may accept to extend the term to 10 years for banks that manage to complete the 20% cash contribution to capital requirement.

Sovereign Debt



Conclusion: So, what is the correct approach?

A key principle of banking maintains that the determination of "adequate" capital depends on the risk profile of the bank.

If both domestic and foreign currency government bonds are vulnerable to default, shouldn't we expect banks to hold capital sufficient to reflect the risks associated with this investment?

Top 5 things to consider for Sovereign Debt
✓ We must not assume that all sovereign debt is risk free.
✓ To assess the capital adequacy of banks operating in highly vulnerable markets, consider adjusting the CET1 ratio by adding a capital requirement for their sovereign bond holdings.
✓ Look for indicators of weakness. For example, if we had monitored the rising trend in the interest rates paid by Lebanese banks on USD deposits since 2017, the collapse of the currency was not a surprise, as the situation was untenable.
✓ Market indicators are always useful but not always timely. Consider how late in the day the black market USD: LBP foreign exchange rates started to deviate from the official exchange rate. At this writing the official USD exchange rate remains 1,507.5 but the black market rate has reached 17,950.

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