Basel III Treatment of Sovereign Debt*

Raymond Natter

November, 2012

One criticism of the existing Basel capital framework that was voiced in the aftermath of the financial crisis was that it encouraged financial institutions to purchase mortgage-backed securities by assigning these instruments a low risk weight. Ironically, the proposed Basel III capital regulation would provide an even stronger incentive for financial institutions to purchase sovereign debt instruments issued by European countries that are facing significant economic problems. This provides additional evidence that the Basel III proposal needs to more carefully align risk and capital requirements.

Under the Basel III proposal, the risk weight applied to the debt of a foreign country (including an agency, ministry or central bank of that country) is to be determined by reference to the “Country Risk Classification” assigned to that country by the Organization for Economic Cooperation and Development (OECD). The framework only applies this rule to countries that are members of the OECD. The Country Risk Classification is intended as an assessment of a country’s credit risk, and the agencies are proposing to substitute this classification for credit ratings issued by nationally recognized statistical rating organizations in light of section 939A of the Dodd-Frank Act. This provision removed references to credit rating agencies from federal statutes.

The Country Risk Classification is derived from two inputs: (i) a quantitative model that produces an assessment of a country’s credit risk, and (ii) a qualitative assessment of credit risk that takes into account political risk and other factors not captured by a quantitative analysis. Countries are then classified into a risk category of 0-7, with 0 having the lowest risk and 7 having the greatest risk.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

The risk weight assigned to a country's debt is correlated with the Country Risk Classification as follows:

Risk Weight	Country Risk Classification
0%	0-1
20%	2
50%	3
100%	4-6
150%	7
150%	Sovereign Default

Additionally, the proposal provides that a risk weight of 150 percent should be applied to sovereign exposures immediately upon determining that an event of sovereign default has occurred or if an event of sovereign default has occurred during the previous five years.

An examination of the Country Risk Weights published by the OECD on October 12, 2012, reveals that the Basel III proposal would assign a 0 percent risk weight to the sovereign debt of many countries experiencing economic stress. For example, debt issued by Ireland, Italy, Portugal, Spain, France and Greece would have a 0 risk weight. Debt issued by these countries pay significantly higher interest rates than comparable U.S. Treasury instruments, yet would require no higher capital charge under the Basel III proposal.

The low capital charge, coupled with the higher return, may provide a strong incentive for some institutions to increase their exposure to risky foreign country debt. The Basel III proposal, therefore, may have the unintended consequence of actually increasing the risk in the banking system rather than reducing it. This anomaly exists in other provisions in the proposal, where there appears to be a disconnect between the proposed capital charge and the risk of the investment. Now that the agencies have decided to postpone the implementation date of the Basel III framework, they should use this time to carefully consider this and other provisions that may increase, rather than decrease, the risk in the financial system.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.