

Box 8

ASSESSMENT OF THE RISKS OF EU BANKS' EXPOSURES TO SOVEREIGN DEBT AS REVEALED IN THE EXERCISE UNDERTAKEN BY THE COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS)

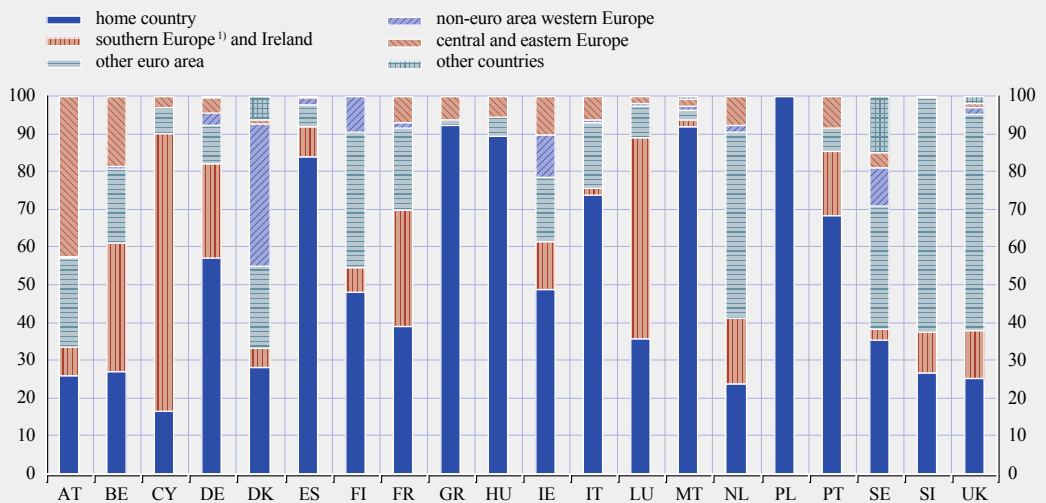
The EU-wide stress-testing exercise that was carried out in July 2010 involved, among other features, the disclosure of the exposures of all 91 participating banks to 30 European sovereigns.¹ The reason for this extensive disclosure was to provide a harmonised source of information to market participants and, thereby, to help them in assessing the scope of potential losses by individual institutions that would arise from fluctuations in the value of sovereign debt. The exercise provided evidence that the EU banks' trading-book holdings of foreign sovereign debt securities are unlikely to be large enough to create a direct channel for the propagation of systemic risk, which is somewhat contrary to the views held by some market participants prior to the disclosure.

The information that was disclosed revealed that the sovereign exposures of EU banks are primarily to the home country sovereign (see Chart A). This holds particularly true for most southern European countries, as well as for Germany and EU Member States in central and eastern Europe (the CEE region). The more significant cross-border sovereign exposures are typically associated with cross-border banking activities, i.e. business through branches and subsidiaries in host countries. For example, banks in France, Austria and the Benelux countries have exposures to various European sovereigns, but these arise mainly from the holdings of their

1 In the EU-wide stress-testing exercise, sovereign exposures included loans and receivables as well as securities.

Chart A Sovereign exposures of banks participating in the EU-wide stress-test exercise to EU countries

(Q1 2010; percentage of total sovereign exposure to EU countries)



Sources: CEBS and ECB calculations.
1) Greece, Italy, Portugal and Spain.

branches and subsidiaries in other EU Member States. In this vein, at the consolidated (or group) level, Austrian banks are exposed to CEE sovereigns, while French banks hold securities issued by sovereigns in Belgium and in southern European countries where they have significant banking activities. Of all countries, Dutch banks turned out to have the most diverse holdings of sovereign debt, with significant exposures to Germany and France, which can be partially traced to cross-border banking activities, but may also reflect the diversification by banks of their sovereign credit risk. All in all, the disclosed information suggests that 81% of all sovereign exposures reported by banks are held in the banking books, which holds particularly true for smaller banks.

As the sovereign yields of some EU countries under fiscal consolidation increased sharply in early May 2010, some market participants attempted to determine potential contagion channels of sovereign risk and their likely impact on the European banking system. However, the preliminary estimates of banks' losses stemming from sovereign exposures, done by market analysts, were plagued by data constraints (in particular, they relied to a large extent on assumptions with respect to the country-level breakdown of banks' sovereign portfolios). In addition, many estimates suffered from inaccuracies that arose from incomplete information about the allocation by banks of their holdings to the banking or trading books. Against this background, individual disclosure of sovereign exposures can be seen as an essential improvement in terms of the transparency and better understanding of banks' holdings of sovereign debt.

In the absence of harmonised data on the banks' sovereign exposures, information from the consolidated banking statistics – compiled and disseminated by the Bank for International Settlements (BIS) without a breakdown by the type of counterparty or creditor country – has sometimes been used to provide an approximation of the scale of cross-border sovereign exposures. However, the information disclosed in the context of the EU-wide stress-test exercise reveals that the bulk of cross-border exposures within the EU banking system are to private counterparties in the debtor countries. Indeed, total cross-border claims by banks on EU sovereigns account for less than 15% of total cross-border claims on EU countries (albeit with large cross-country variation). The rest of the exposures consist of loans extended to, and holdings of securities issued by, private sector counterparties. These findings seem also to be in line with the more detailed foreign claims data, which have been published by the BIS for a subset of euro area countries since June 2010.²

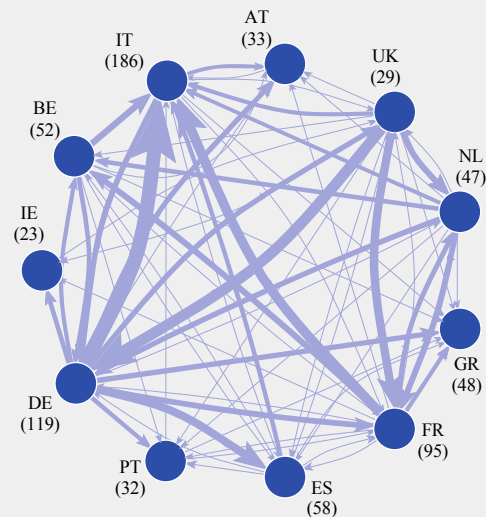
Furthermore, the approximation of sovereign exposures on the basis of the BIS consolidated banking data is impaired by the fact that the share of cross-border sovereign exposures in total claims on EU countries is not uniform across countries (see Charts B and C). To illustrate this, the United Kingdom and Greece serve as good examples. BIS data suggest that foreign claims of banks in ten euro area countries³ that report to the BIS on counterparties in the United Kingdom account for 27% of these banking sectors' total foreign claims. The corresponding figure for sovereign exposures, as reported by banks, is merely 5%. The foreign claims of banks in the countries under analysis on Greece would amount to 2% of their corresponding total exposures according to the BIS figures and to 7% on the basis of banks' own sovereign disclosure.

2 The June and September 2010 BIS *Quarterly Reviews* present total consolidated exposures of banking groups headquartered in seven developed economies to the public, banking and private non-bank sectors in four euro area countries: Greece, Ireland, Portugal and Spain. The complete dataset covering additional countries is currently not publicly available.

3 Austria, Belgium, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain.

Chart B Foreign claims on sovereigns, broken down by nationality of the reporting banks in selected EU countries

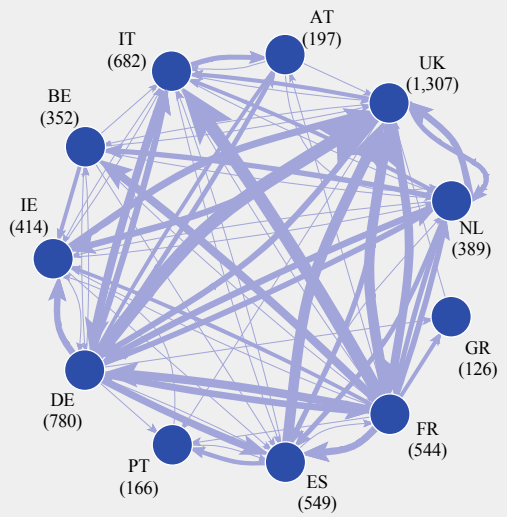
(Q1 2010; EUR billions)



Sources: CEBS and ECB calculations.
 Notes: The direction of the arcs reflects the direction of lending of funds and the thickness the size of the total exposure. Arcs for lending less than €1 billion are excluded for better readability. The total cross-border sovereign exposure of banks in the 11 selected EU countries to the particular country is reported by the numbers in brackets. The thickness of the arcs is scaled, so that an arc in Chart B represents an exposure that is equal to one-fifth of the exposure represented by an arc of the same thickness in Chart C.

Chart C Foreign claims, broken down by nationality of the reporting banks in selected EU countries

(Q1 2010; EUR billions)



Sources: BIS and ECB calculations.
 Notes: The direction of the arcs reflects the direction of lending of funds and the thickness the size of the total exposure. Data are given on an immediate borrower basis. Arcs for lending less than €10 billion are excluded for better readability. Total foreign claims on the particular country of banks in the 11 selected EU countries are reported by the numbers in brackets. The thickness of the arcs is scaled so that an arc in Chart B represents an exposure that is equal to one-fifth of the exposure represented by an arc of the same thickness in Chart C. The thickest arc represents the maximum bilateral exposure of €358 billion.

As a result, in this context, applying the BIS statistics which are publicly available for the approximation of sovereign exposures can paint a somewhat misleading picture of the pure sovereign credit risk exposures of European banks due to the fact that the BIS data also cover exposures that go beyond the sovereign domain.⁴

⁴ On the potential risks arising from the use of BIS data as a proxy for banks' sovereign debt holdings, see also the CEBS statement of 8 September 2010 on the disclosure of sovereign exposures in the context of the 2010 EU-wide stress-testing exercise (available at [http://www.c-ebs.org/documents/News---Communications/2010/CEBS-2010-194-rev2-\(Statement-on-disclosures-of-so.aspx\)](http://www.c-ebs.org/documents/News---Communications/2010/CEBS-2010-194-rev2-(Statement-on-disclosures-of-so.aspx))).