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March 9, 2018

Mr. William Coen  
Secretary General  
Basel Committee on Banking Supervision  
Bank for international Settlements  
CH-4002 Basel  
Switzerland

**Re: BCBS Discussion Paper on The Regulatory Treatment of Sovereign Exposures**

Dear Mr. Coen:

The Institute of International Finance (IIF) appreciates the opportunity to provide comments on the Basel Committee on Banking Supervision (the “Committee” or “BCBS”) Discussion Paper on *The Regulatory Treatment of Sovereign Exposures*. We value the opportunity to provide our feedback on the important issues raised by the Discussion Paper, as well as the ongoing dialogue that the BCBS has conducted with the industry on this topic.

**Introduction**

From the outset, we would like to emphasize that our comments to the discussion paper are exploratory in nature and developed in the spirit of contributing to an exchange of views with the public sector on what undoubtedly is an extremely complex set of issues. The regulatory treatment of sovereign exposures involves sensitive risk, economic, fiscal, monetary, and even political matters that are well known by all participants in this discussion and on which there are wide ranges of opinions, both within the private and public sectors. In fact, the difficulties of the regulatory community on reaching an agreement on any potential policy changes demonstrate the challenging nature of this topic.

These exploratory comments are based on the premise, recognized in the Discussion Paper and in statements by Basel Committee officials, that there is no intention at this stage to develop new regulatory policy on the prudential treatment of sovereign exposures. The IIF supports the Committee’s decision to retain the current treatment of sovereign exposures, and we stress that with the finalization of Basel III, a period of policy stabilization is essential in order to ensure that those changes are consistently and fully implemented across jurisdictions. The introduction of a new Sovereign framework before the changes are set in would compound the existing environment with further uncertainty and changes.

In this sense, the industry believes that further policy changes (including any potential changes in the area of sovereign exposures) should be avoided in order to allow the recently completed G20 regulatory reform agenda to settle, be implemented and continue to produce its beneficial

effects on financial sector resilience and stability. In addition, we observe that the changes proposed in the 2016 Fundamental Review of the Trading Book (FRTB) regarding sovereign exposures were not part of the type of holistic approach that the Committee now recognizes as necessary for any policy review in this area. Such changes in the FRTB framework should be reconsidered as they create an unjustifiable inconsistency between the banking book and the trading book in this important area. These FRTB related changes are highlighted and commented upon in a standalone letter by the IIF together with other trade associations.

The holistic considerations of all the issues involved in the regulatory treatment of sovereigns should take into account the important role that the sovereign exposures have in the banking system, financial markets, and the broader economy, as recognized by the Committee. For instance, the so called “home bias” when dealing with sovereign holdings has some positive ramifications for financial stability, playing a crucial role as a counter-cyclical stabilizer in time of crisis or during downturn. Hence, the specific nature of the sovereign exposures should be emphasized and properly recognized in the framework to avoid negative consequences to the development and growth of the real economy. For example, sovereign guarantees support international trade and economic growth, specifically in the developing markets through export credit agencies.

Taking into account the complex relationship between banks and sovereigns (sovereign-bank nexus), it is important to be fully cognizant of the potential consequences of revising in isolation the prudential treatment of sovereign exposures without addressing the multiple economic, fiscal, monetary, and political issues that are integral components of this complex topic. As recognized by the Committee, there is no guarantee that banking sectors can be completely isolated in the event of a sovereign debt crisis, even if banks were to hold no governments bonds at all in their portfolios. A sovereign crisis would ultimately affect also the real economic sector that in turn would determine a deterioration of banks’ asset quality, worsening their creditworthiness profile. The nexus might become even stricter and it would convert in an “accelerator” of sovereign crisis.

Moreover, introducing new regulatory requirements on sovereign exposures can produce unintended effects on banks’ liquidity, which are discussed in more detail below. The increased cost of the collateral can reduce the banks’ ability to underpin their own sovereign debt market with the unavoidable increase in government’s funding costs. As a result, banks can face difficulties in complying with the new regulatory liquidity constraints such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

The treatment of sovereign risk exposures is a delicate and complex topic that has proven difficult to reconcile at the international level; in fact, we are concerned about the potential unintended consequences of implementing the ideas presented in the Discussion Paper, including:

- Increased pro-cyclicality (through Risk Weighted Assets (RWA) sensitivity and linkage to external ratings)
- Reduced availability of financing for sovereigns in a downturn (potentially worsening the downturn and have a systemic impact on the financial system)
- Herding and cliff effects if all banks need to rely on the same external ratings (or if the risk-weight categories are not granular enough)

- Increased politicization of public ratings, raising questions to governance and oversight of sovereign rating assessments by these agencies
- Concentration risk charge incentivizing those banks currently concentrated in high quality sovereign assets to diversify into lower quality assets and conversely imposing severe negative carry costs for banks situated in more risky countries including emerging markets and developing economies

## General Comments

Our detailed responses to the questions posed in the Discussion Paper are set out in the following pages. However, we wish to highlight the following six themes:

- We welcome the recognition of the different roles of sovereign exposures and the analysis of the drivers for banks to hold sovereign bonds. The primary purposes for which banks hold sovereign exposures are to meet their liquidity obligations (such as under the Liquidity Coverage Ratio), in the form of collateral on derivatives transactions, and to provide liquidity to the financial system, thereby managing risk and enabling market functioning; this is a different context to exposures that banks hold for investment purposes.
- In regard to risk weighting, the IIF continues to favor the current approach in the framework for the treatment of sovereign exposures, allowing a choice between an Internal Ratings Based (IRB) approaches and a Standardized Approach (SA). We note that the reliance on the SA alone would result in amplified detrimental and contagious consequences. It is our view that the IRB approaches should be retained as an option, and we continue to support efforts to improve and strengthen the regulatory capital framework and ensure the credibility of RWA calculations.
- There is a range of views within the industry regarding the potential definition of sovereign exposures. Some firms welcome and support the differentiation between central banks and other government exposures, as well as the definitions provided for different sovereign entities to enhance clarity and consistency in implementation. On the other hand, other firms are of the view that in certain cases this distinction is not appropriate. Specifically, a case-by-case determination if aggregation of sovereign exposures is appropriate to allow flexibility for differences in the types of entities, structure of entities, legal framework, and precedents, which vary from jurisdiction to jurisdiction.
- The extent of the roles governments play in their economies varies greatly across jurisdictions. In some countries the state ownership of financial and corporate entities is significant whereas in others, minimal. Considering these jurisdictional variations, we disagree with the idea to introduce any framework that limits sovereign holdings. Banks' role in supporting local real economies where government control and ownership is extensive, should not be inhibited.
- Banks should be able to assess the risk of sovereign exposures themselves, and use their own models for risk differentiation (i.e. assessing the sovereign). It is particularly important to understand the distinction between (i) model development, i.e. risk assessment, where banks independently rate (or rank-order) sovereigns using internally developed models, and (ii) calibration. The diversity of banks models and risk

assessment remains the best solution to avoid herd behaviour and cliff effects which can jeopardize, rather than reinforce, financial stability.

- The financial crisis raised questions about the reliability of public ratings by recognized rating agencies, and OECD ratings are not generally considered as default ratings. We are concerned that some of the treatments set out in the Discussion Paper could create disparities, especially because some jurisdictions are allowed to use external ratings while other jurisdictions have to rely on the Country Risk Classification (CRC) score of the Organisation for Economic Co-operation and Development (OECD). As a consequence, treatment of sovereign exposures becomes less comparable and less risk sensitive. Should either or both forms of ratings play a role in any sovereign framework, a specific set of standards, applicable to the ratings should ensure the robustness of their outcomes. Many banks rely on the use of public credit ratings in model development, however the use of IRB necessitates an added level of rigor (as previously discussed), that is furthered by the increased level of risk monitoring.

The following comments expand on some of the key points we raised above. For the specific answers to the questions posed in the Discussion Paper, please see the attached Appendix.

**Firstly**, we welcome the Committee's decision to allow for a period of policy stabilization, in order to fully and consistently implement the new regulatory framework recently finalized, rather than proceeding to consider and potentially implement further changes. The lack of agreement at international level reflects the degree of challenge that this discussion poses. In effect, changes to the current treatment of sovereign exposures could have significant adverse consequences for the financial system and for financial stability, which require a careful and considered approach.

**Secondly**, the IIF continues to favor the current approach in the framework for the treatment of sovereign exposures, allowing a choice between an Internal Ratings Based (IRB) approaches and a Standardized Approach (SA). Furthermore, we note that the reliance on the SA alone would result in amplified detrimental and contagious consequences. For instance, if a sovereign is downgraded with a framework reliant on public or OECD ratings binding on all banks, it would put capital pressures on all banks to simultaneously, potentially triggering a flight from exposures to that sovereign across the banking system. If banks could use their own models, the reflection of credit deterioration in risk weighted assets would vary across institutions. It is our view that the IRB approaches should be retained as an option, and we continue to support efforts to improve and strengthen the regulatory capital framework and ensure the credibility of RWA calculations. It is important to note that internal models have proven their validity as a risk sensitive way of measuring capital requirements, allowing for alignment of the financial institutions' own risk assessments and their capital allocation based on well-developed internal risk management practices. This view is supported by the outcome of the recently finalized Basel III package.

Since the adoption of the Basel II Accord, banks have demonstrated their ability to assess and rank order their sovereign exposures. When supported with robust governance processes, the IRB models are an efficient tool for prudential capital allocation. In this context, it is important

to differentiate between model development and calibration, which we discuss in more detail below<sup>1</sup>.

Banks' Probability of Default (PD) estimates are typically first rank ordered by taking a number of risk indicators as inputs and giving ordinal discrimination buckets into which obligors are placed according to their characteristics. Typically, the calibration phase then compares the outcomes with observed default rates and translates it into a "final PD". It is particularly important to note that the resulting estimates account for the data-heavy requirements incorporated into the Basel framework.

In this context, we also wish to note our concern regarding the existing regulator imposed LGDs; based on the recovery histories that have been observed on sovereign exposures, these are unduly punitive for this asset class, and create non-level playing fields via national divergences (i.e. these are imposed in different ways by national authorities).

Additionally, it is unclear how the recognition of third country sovereign exposures should be treated. For example, in the EU CRR<sup>2</sup> rules, under the SA an exposure can get 0% if it is funded and denominated in the domestic currency, and the sovereign is in the EU. A bank can also treat third country sovereign exposures in accordance with local rules (often similar – 0% if funded and denominated in local currency) if the country is deemed to apply supervisory and regulatory arrangements at least equivalent to the EU. However, other non-EU countries have their liquidity in local currency government bonds funded by local currency liabilities and some are not recognised as equivalent supervisory regimes.

**Thirdly**, as briefly highlighted above the primary purposes for which banks hold sovereign exposures are to meet their liquidity obligations (such as under the LCR) in the form of collateral on derivatives transactions, and to provide liquidity to the financial system, thereby managing risk and enabling market functioning; this should be considered in a different context to exposures that banks hold for investment purposes. It is important therefore to highlight that sovereign exposures play an important role as part of monetary-fiscal policy operationalization in the banking system, financial markets, and the broader economy.

To this end, we stress that revising the current regulatory treatment would entail an abrupt change in regime and regulation with a potential unintended impact on financial stability, as they risk pushing more banks to hold the higher quality sovereign paper – in effect worsening concentration risk for some firms but also some sovereigns. Additionally, there is the risk that they may shrink the pool of eligible/acceptable collateral banks will accept as margin and use to conduct repo-financing trades. Additional consequences may be that the high-quality liquid assets (HQLA) would need to be revised if certain government bonds become less liquid (i.e. resulting in the HQLA criteria being relaxed to accept less liquid assets or the liquidity of lower

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<sup>1</sup> This differentiation was more recently discussed by in the EBA's recently published *Guidelines on PD Estimation, LGD Estimation, and Treatment Defaulted Exposures*.

<sup>2</sup> Capital Requirements Regulation (EU) No. 575/2013

quality papers will deteriorate further making these ineligible for HQLA), and that government borrowing costs are likely to rise.

**Fourthly**, there is a range of views in the industry on the potential definition of sovereign exposures. Some firms welcome and support the differentiation between central banks and other government exposures, as well as the definitions provided for different sovereign entities to enhance clarity and consistency in implementation. On the other hand, other firms are of the view that in certain cases this distinction is not appropriate.

Those that support this differentiation, clearly welcome the distinction between central banks and other government exposures. This differentiation is particularly important and necessary when banks have mandatory requirements to hold certain reserves in central banks, or when monetary policy operations make banks have positions with central banks. These banks also note that definitions need to be considered not only by types of entities, but also by type of bank exposures, as different instruments have proven to behave very differently in sovereign restructuring cases. Additionally, the nature of and hence the risks associated with exposures to central banks and other government entities can be very different. With maturities as an example, overnight cash deposits at central banks are short-term exposures, whereas derivatives and funding exposures to government can be much longer.

However, we note that in certain cases, risk of exposure to central government and central bank cannot be separated. Such is the case of jurisdictions where central government and central bank can effectively be integrated in an extreme case of central banks' default (have the same sovereignty, and are under the same currency), in which case there may not be a meaningful point of differentiation. Additionally, the difference between two entities may come from maturity differences (i.e. while exposure to central banks is short-term, government exposure could be longer), but this is captured as interest rate risk issues, and hence already addressed through the finalized Basel III framework.

In this vein, we note that significance of state ownership of sovereign entities is different across jurisdictions, and the nature of the relationship between central banks and sovereigns can also vary; hence the importance for - the framework to allow these differences to be reflected. Most countries have several different levels of government (e.g. federal, state or province, municipality) and depending on the legal framework of the country, it is possible that a default of a state, province or municipality would not trigger the default of other sovereign exposures. Sovereigns often do not provide explicit guarantees to debt issued by the sub-sovereign entities, and consequently do not have a legal responsibility to honor debt defaulted by sub-sovereigns. Different levels of implicit support from sovereigns have different levels of risks.

With consideration to the above, we note that in certain instances, a case-by-case determination if aggregation of sovereign exposures is appropriate to allow flexibility for differences in the types of entities, structure of entities, legal framework, and precedents, which vary from jurisdiction to jurisdiction.

**Fifthly**, we wish to highlight the difference between (i) model development and (ii) calibration. Ratings are only a process for obtaining a PD. This differentiation was more recently discussed by in the European Banking Authority's (EBA) recently published *Guidelines on PD Estimation, LGD Estimation, and Treatment Defaulted Exposures*.

- **Model development** is the process that leads to risk differentiation, it is commonly referred by banks as rating a counterparty, rank ordering, scoring, producing a “uncalibrated PD”. Rank ordering is taking a number of risk indicators as inputs and giving ordinal discrimination buckets into which obligors are placed according to their characteristics. This can be obligor-specific risk drivers as well as risk drivers closely related to the cycle.
- **Calibration** is the part of the process that leads to risk quantification. Typically, this compares the outcome of the Model Development phase with observed default rates and translates it into a “final PD”.

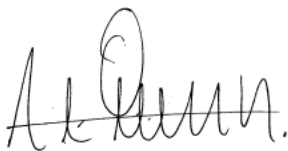
It is our view that banks should be allowed the option to assess the risk of sovereign exposures themselves, and use their own models for risk differentiation.

**Sixthly**, since the adoption of the Basel II Accord, banks have demonstrated their ability to assess and rank order their sovereign exposures. Many banks rely on the use of external credit ratings in model development, however the use of IRB permits an added level of rigor in terms of data-heavy requirements, reinforced by the increased monitoring of risk.

**Finally**, some regulators do not approve the use of external rating agencies, resulting in two different calculations. It is our view that OECD classifications are inappropriate and do not fit as a sovereign rating. Firstly, the OECD classification is purely for Export Credit Agencies (ECAs), i.e. is a rating of exporting possibilities and risks on the export side. Secondly, its use will create anomalies from having two different calculations, for example a zero percent risk weight given for OECD countries versus a non-zero risk weight from an external rating agency. Therefore, it is important to separately consider the case of jurisdictions that do not allow the use of external ratings and unrated sovereign exposures. In these cases, there may be a need to develop common criterion for grading of central government exposures similar in scope to those contained in the Committee’s list of monitoring indicators of sovereign risk. In this vein, we note that a different set of indicators may be needed for the risk assessment of subnational government and public sector entities.

The IIF hopes that our exploratory comments are helpful and useful to the Committee. If you have any questions on the issues raised in this letter, require further input, or any necessary expansions or clarifications on our comments, please contact myself or my colleague Natalia Bailey ([nbailey@iif.com](mailto:nbailey@iif.com)).

Sincerely,



## **APPENDIX - RESPONSES TO THE 14 QUESTIONS POSED IN THE DISCUSSION PAPER**

The attached appendix contains our detailed responses to each of the 14 questions posed in the Discussion Paper.

### **Q1: Are there any additional sources and channels of sovereign risk in the banking system that are relevant to, and that should be captured in, the prudential regulatory treatment of sovereign exposures?**

The IIF considers that the sources and channels of sovereign risk in the banking system listed in this subsection are sufficiently clear. We wish to highlight the role of bank loans, and to note that the sovereign-bank nexus is also relevant to banks linked to local municipalities.

### **Q2: Are there any additional roles of sovereign exposures in financial markets and the broader economy that are of relevance to the prudential regulatory treatment of sovereign exposures?**

The IIF agrees with the discussion on the roles of sovereign exposures in financial markets and the broader economy relevant to the prudential regulatory treatment of sovereign exposures. In addition, we consider that the Discussion Paper fails to acknowledge sovereign exposure relevant for export finance, used by various banks. Financing of exports to high-risk jurisdictions can benefit from export finance support through ECAs. For the bank providing the financing this transforms credit exposure to sovereign exposure. *The answer to this question should be read together with our answer to Questions 3, 4, 5 and 9, where we also discuss the impact of sovereign exposure for export finance.*

### **Q3: What are your views on the potential definition of sovereign exposures?**

There is a range of views in the industry regarding the potential definition of sovereign exposures. Some banks are supportive of and welcome the differentiation between central banks and other government exposures as well as the definitions provided for different sovereign entities to enhance clarity and consistency in implementation while other banks, are of the view that in certain cases this distinction is not appropriate.

Specifically, a case-by-case determination if aggregation of sovereign exposures is appropriate to allow flexibility for differences in the types of entities, structure of entities, legal framework, and precedents, which will vary from jurisdiction to jurisdiction.

Those that support this differentiation, clearly welcome a distinction between central banks and other government exposures. This differentiation is particularly important and necessary when banks have mandatory requirements to hold certain reserves in central banks, or when monetary policy operations make banks have positions with central banks.

However, we note that the definition needs to be more meaningful in providing differentiation in risk weights between different categories of sovereign exposure, i.e. central banks vs central government and/or sub-sovereign, as well as local- versus foreign-currency exposure, in particular because for various banks ECAs are very relevant.



Regarding the implementation of risk weights as suggested in the discussion paper, some banks believe that a more granular bucketing of risk weights would be helpful to increase risk sensitivity and reduce cliff effects. Those supporting this approach feel that consideration should be given as to whether this could be implemented through a notching up and down approach for sub-sovereigns (e.g. depending on the level of independence or support the rating could be adjusted downwards by a number of notches). A similar approach could be taken for exposures in local currency, which can be notched up from the corresponding foreign-currency rating, rather than setting distinct risk weights for them.

Additionally, Sovereign Wealth Funds that have evidence of strong support from the Sovereign and essentially act on the behalf of the Sovereign should be classified as sovereigns.

As indicated in Question 2, financing of exports to high-risk jurisdictions can benefit from export finance support through ECAs. This has an impact on the definition of central government entities (some ECAs are the government, in other cases they receive government support), therefore they should not be treated differently for Sovereign Risk purposes. Additionally, Multilateral Development Banks (MDBs) should also be aligned with ECAs. *The answer to this question should be read together with our answer to Questions 2, 4, 5 and 9, where we also discuss the impact of sovereign exposure for export finance.*

With regard to those that do not support this differentiation, we note that in certain cases, risk of exposure to central government and central bank cannot be separated. Such is the case of jurisdictions where central government and central banks effectively be integrated in an extreme case of central banks' default, (have the same sovereignty, and are under the same currency), in which case there may not be a meaningful point of differentiation. Additionally, the difference between two entities may come from maturity differences (i.e. while exposure to central banks is short-term, government exposure could be longer), but this is captured as interest rate risk issues, and hence already addressed through the finalized Basel III. Likewise, these banks also believe that there is no issue with the current bucketing of risk weights.

Additionally, some banks in emerging markets have noted that it may be challenging to determine the risk equivalence criteria as it is subjective and open to interpretation, and that a more objective criterion is needed, such as rating availability. If an entity is rated, then it may be deemed to have an autonomy criterion. Other comments from emerging country banks are as follows:

- For public sector entities under other sovereign entities, the definition may include an entity or company which may be considered as “quasi sovereign” if a government owns more than 50% of either the entity’s equity or the company’s voting rights.
- It may be challenging to determine if a central bank’s monetary policy is centered on the exchange rate. Also, there may be subsequent changes in the central bank’s monetary policy stance, which may result in a change in the risk weights.

**Q4: Do you agree that the definition of domestic sovereign exposure should be based on both the currency denomination of the exposure and the currency denomination of the funding? How would such a definition be operationalized in practice?**

The IIF agrees that the definition of domestic sovereign exposure should be based on the currency denomination of the exposure, however we do not agree that the definition of the local currency sovereign exposure should also depend on the denomination of the funding, with a caveat for export credit sovereign exposures.

The main reduction in the riskiness of local currency sovereign exposure as compared to foreign currency sovereign exposure comes from the ability of the sovereign to conduct its own monetary policy and print the local currency. In our view, this reduction in riskiness is entirely independent of how a bank chooses to fund its exposure. The bank's funding strategy will influence liquidity, currency, and cross border risk, but this should be assessed separately. The BCBS Discussion Paper acknowledges that in practice funding sources are somewhat fungible and not necessarily linked to specific assets. We agree with this observation and believe that any differences in the risk weighting of sovereign entities should therefore solely reflect whether the exposure itself is denominated in the domestic currency. Therefore, the currency denomination of the funding sources should be excluded from the assessment.

In terms of how such a definition be operationalized in practice, it is unclear how it would be operationalized in the case of globally decentralized banks. Domestic sovereigns can end up appearing as foreign sovereign debt due to banks' consolidation processes. Given that some banks apply capital requirements at the group level, domestic sovereign exposures held by a subsidiary can appear as foreign sovereign debt for the parent undertaking, even if these exposures are denominated and funded in the local currency of the subsidiary. It is important to avoid this distorted treatment for global decentralized banks. *This point also relates to Question 5 and 13.*

In the case of export credit sovereign exposures, where the exposure is almost always in foreign currency, in particular USD or EUR, we note that the impact on the definition of central government entities (i.e. in relation with ECAs) would mean that any distinction on the risk-weight of Local Currency versus Foreign Currency would disadvantage such export financing, (i) when the exporting guarantee is from a jurisdiction other than the one of the loan's currency and (ii) especially given the dominant role of USD for such export financing, it would de facto penalise any guarantee other than from a U.S. ECAs. *The answer to this question should be read together with our answer to Questions 2, 3, 5 and 9, where we also discuss the impact of sovereign exposure for export finance.*

Lastly, we deem it appropriate to take into account foreign exchange risk mitigation when granting a preferential treatment for both (i) domestic currency sovereign exposures funded in the same currency, and (ii) to sovereign exposures in the domestic currency funded in a different currency but subject to a FX swap. This enables the bank to mitigate the foreign exchange risk associated with the operation, and from a risk standpoint, the sovereign exposures can be considered to be denominated and funded in the same domestic currency.

**Q5: Do you agree with the potential relative rank ordering of different sovereign entities and with the principle of a potential risk equivalence criteria for treating certain non-central government exposures as central government exposures? Do you have any comments on the criteria?**

*Please refer to Questions 2, 3, 4 and 9 for the discussion of the impact of sovereign exposure for export finance.*

The IIF agrees with the potential relative rank ordering of different sovereign entities, and believes that the definition brings clarity to which entities can be treated as central governments. However, there could potentially be inconsistencies between the treatments of sovereign entities at host and home/consolidated reporting given that different countries have different legislations.

Additionally, we note that the distinction of sub-sovereigns, and regions, and municipalities cannot be neglected, given that a large part of sovereign exposures are to these. This point is particularly important on decentralized countries.

Additionally, European banks have noted that the current risk weights discussed for subnational governments are considered higher than in the EBA list for entities (e.g. provinces and cities). It is unclear the rationale behind discussing higher risk weights based on that categorization irrespective of the rating, in particular given that the overall approach is rating centric. Therefore, we would argue that a AAA should be a AAA irrespective to which tier is under.

We also wish to emphasize the importance of the international aspect in this discussion, even if EBA has issued a list for European use, other jurisdictions will agree with what the local regulators have accepted, this leaves room for unlevel playing fields, misconceptions and discrepancies between the local reporting and the consolidated reporting going back to the point earlier discussed.

We seek clarification if this is grouping entities such as sovereign wealth funds, and what criteria should apply for them (i.e. they get included in criteria B, or the support criteria).

**Q6: Do you agree that capital requirements for sovereign exposures cannot be modelled robustly and that such exposures should be subject to a standardized approach treatment as a result?**

As indicated in our General Comments, we continue to favor a choice between a SA and IRB approach. A statistically robust PD model giving good risk ranking ability can be built in a similar manner a bank/ FI model is developed currently for IRB purposes.

As stated in our General Comments in the letter, it is our view that internal models have proven their validity as a risk sensitive way of measuring capital requirements. Banks have demonstrated their ability to assess and rank order their sovereign exposures critically. Banks' PD estimates are typically first rank ordered by taking a number of risk indicators as inputs and giving ordinal discrimination buckets into which obligors are placed according to their characteristics. Typically, the calibration phase then compares the outcomes with observed default rates and translates it into a "final PD". It is particularly important to note that the resulting estimates account for the data-heavy requirements incorporated into the Basel framework.

The IIF disagrees with the notion that banks cannot model sovereigns, and that as a result these exposures should be subject to a SA treatment. In reconsidering the validity of the IRB approaches, and in the context of the finalized Basel III package and ongoing discussions of FRTB, we also wish to note our concern regarding the existing regulator PD floors and imposed LGD values. Where some regulators are directing the LGD values that are to be used, these can

be unduly punitive for this asset class, and have the potential of creating non-level playing fields via national divergences (i.e. these are imposed in different ways by national authorities).

As discussed in the General Comments section, the issue is not that banks cannot model sovereigns, but rather the calibration. In Questions 7-8 of the Discussion Paper, the Committee asks what additional questions should be added to the SA, however, if a bank has to add questions, then the bank needs to have a model to look at the multitude of risk drivers and come up with an internal model to capture the top six or ten.

Another point directly linked to this question, is the difference between (i) model development and (ii) calibration (discussed in more detail in the General Comments section). It is our view that banks should be able to assess the risk of sovereign exposures themselves, and use their own models for risk differentiation (i.e. assessing the sovereign)<sup>3</sup>. Ratings are only a process for obtaining a PD. Banks have proven their ability to risk differentiate, (i.e. rate a counterparty, rank order, score, or produce an “uncalibrated PD”). Banks methodologies are thoroughly reviewed to ensure the robustness of their outcomes. As part of the rank ordering banks take a multitude of risk indicators as inputs and give ordinal discrimination buckets into which obligors are placed according to their characteristics. This are usually a combination of obligor-specific risk drivers as well as risk drivers related to the cycle. For the most part, the calibration part entails a secondary step in the process which leads to risk quantification.

External ratings have been put into question in the past<sup>4</sup>. We encourage regulators and supervisors to build a specific framework for external ratings, to ensure that their methodologies go through similar tests and procedures that banks are subjected to ensure the robustness of their outcomes. In this vein, it is important to consider the SA alongside the IRB, ensuring that IRB remains an alternative.

The treatment of sovereign risk exposures is a difficult topic to reconcile, and we reflect on the potential unintended consequences. We list herding and cliff effects if banks need to rely on external ratings (or if the risk-weight categories are not granular enough) as a potential consequence of disallowing the use of IRB, as well as the increased politicization of external ratings.

A major concern is also the use of OECD classification, as this is an export credit agency use purely for ECAs, is a rating of exporting possibilities and risks on the export side, thus not fit to be used as a sovereign rating. The use of OECD classification would create anomalies from having two different calculations, for example, with zero percent risk weight given for all OECD countries that are not reviewed and do not have a Country Risk Classification, versus a non-zero risk weight from an external rating agency.

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<sup>3</sup> This differentiation was more recently discussed by in the EBA’s recently published Guidelines on PD Estimation, LGD Estimation, and Treatment Defaulted Exposures.

<sup>4</sup> The Committee’s 2014 *Revisions to the Standardised Approach for credit risk*, set out an approach that removed all references to external credit ratings and assigned risk weights based on a limited number of alternative risk drivers. It was due to respondents’ views that the second Consultative Document reintroduced the use of ratings.

**Q7: What are your views about how a standardised approach treatment for sovereign exposures should be designed and calibrated? How should such an approach balance simplicity comparability and risk sensitivity? Are there any holistic considerations which could justify a differentiated treatment across different types of sovereign entities, including the relative treatment of central bank and central government exposures?**

The IIF supports the Committee's decision to retain the current treatment of sovereign exposures given their risk diversity across jurisdictions. In regard to some of the approaches described in the discussion paper, we have a number of concerns and observations:

**Firstly**, we draw your attention to an inconsistency arising between the banking book and the trading book, where under revisions in the 2016 FRTB the latter will require a PD floor for sovereign exposures despite the decision by the BCBS to postpone consideration of any changes to the regulatory treatment of sovereign exposures. In this regard, we observe that the same reasons for which it is not prudent at this stage to introduce changes to the treatment in the banking book would apply to those in the trading book, making the case for a consistent approach across the banking and trading book. A separate Joint Association response will focus on the regulatory treatment of sovereign default risk charge in the trading book.

**Secondly**, we have practical concerns around the application of non-rating based indicators and doubt that the idea suggested truly represents a standardized approach because of the many additional judgments a bank is asked to make. The idea as currently written relies heavily on external ratings, with little recognition that not all countries are rated, and fewer municipalities and public sector entities (PSEs); and that not all regulators would accept reliance on external ratings.

**Thirdly**, we maintain the view that banks should be able to assess the risk of sovereign exposures themselves, and use their own models for risk differentiation (i.e. assessing the sovereign), the focus in our view should rather be on the calibration of these models, not at the level of assessment of the sovereigns. Concerns regarding variability of PD estimates are already duly addressed via the enhanced Pillar 2 supervisory scrutiny and Pillar 3 disclosures.

**Fourthly**, many banks rely on the use of external credit ratings in the model development, however the use of IRB adds another level of rigor (as previously discussed), compounded by the increased monitoring of risk. One of the suggestions by Basel in reducing the reliance on external credit ratings included the requirement to perform due diligence on sovereign exposures. Clarification needed on the expectation for a periodic review or on a deal by deal basis as this would require certain level of expertise on sovereign risk.

**Fifthly**, some members believe that the number of risk weight categories need to provide sufficient differentiation of risk so (i) capital charge and risk are meaningfully aligned and (ii) factor in the expanded definition of sovereign exposures in the Discussion Paper that increased the scope of exposures covered by the SA. Reducing the number of standardized buckets by half means within a bucket, there may be exposures that are meaningfully different in risk assessment but attracting the same capital charge. In order to have meaningful differentiation of risks, there should be a risk bucket for ultra-low risk sovereigns, especially for sovereign debt that are widely recognized as flight-to-quality assets and risk-free benchmarks in global

financial markets. In addition, there should be a further split of the “below BBB- and unrated” into more granular categories, to better reflect the different risk profiles of different sovereigns.

**Finally**, a major concern is also the use of OECD classification, as this is an export credit agency use purely for ECAs, is a rating of exporting possibilities and risks on the export side, thus not fit to be used as a sovereign rating. The use of OECD classification would create discrepancies from having two different calculations, for example, with zero percent risk weight given for OECD countries that are not reviewed and do not have a CRC versus a non-zero risk weight from an external rating agency. This would mean that OECD countries that do not get any CRC, would be assumed to be the safest sovereign exposures without any actual risk analysis and attract the lowest haircut, or supervisors will have to rely on banks internal risk monitoring to assign risk weights. The result would be an unlevel playing field between banks that can use external ratings and those that cannot. Those that cannot would still have to rely on internal sovereign risk assessment due to the deficiencies of CRC, such as the small coverage, and the fact that they are not a true default risk rating. In this case, it is best to retain the option of an IRB framework to set level playing field and reduce national discretions.

In addition, it should be clarified whether sovereign risk would be considered eligible to be included in the output floor. An impact assessment should take account of that consideration.

We also seek clarification on whether the options in Section 5 be stand-alone measures or combined.

**Q8: What role could specific non-rating indicators play in determining sovereign exposure risk weights in the potential standardised approach?**

Firstly, as a matter of interpretation, the IIF seeks clarification on the rationale behind the question, as it is not clear whether this question is about the capacity granted for banks to add some layers (criteria) to the rating agencies assessment. On the basis that this is in fact the purpose, then this would question the validity of the assessment (i.e. that the assessment is not perfect). Additionally, the criteria that may be added (e.g. fiscal deficit, and macroeconomic indicators) is likely to have already been aggregated in the rating agencies assessment, so in practical terms it would result in double counting the criteria.

We also want to point out that if the purpose is to reduce reliance on public ratings, then allowing the option of an IRB framework is one way of doing so, and it will ensure consistent adoption and implementation across all banks.

As discussed in previous questions, it is the IIF view that banks’ internal models are better informed than those used by rating agencies.

**Q9: What are your views regarding the potential marginal risk weight add-on approach for mitigating sovereign concentration risk? Do you have any views on the potential design, granularity, and calibration of such an approach?**

The IIF disagrees with the idea to impose marginal risk weight add-ons for mitigating sovereign concentration risk. A marginal risk weight add-on for mitigating sovereign concentration may have wider systemic consequences on the financial system.

Our main concern arises mainly from the revised BCBS rules for Large Exposures, which have not yet been fully implemented in many jurisdictions. The revisions require the mandatory application of a collateral substitution approach under the large exposures rules. The new rules result in a significant increase of the large exposure amounts attributable sovereign exposures. Therefore, to include those increased exposures into the large exposure limits will virtually immediately result in threshold violations with respect to large issuers of sovereign collateral, such as United States Treasury Bills (T-Bills). We are concerned that the Discussion Paper proposals will make the use of sovereign collateral less attractive for banks with the potentially negative implications discussed throughout our response letter.

The IIF's view is that the introduction of a Pillar 1 large exposure limit could negatively impact sovereign debt market liquidity, as well as potentially impact all banking operations collateralized by sovereign assets (i.e. repo-style transactions, derivatives transactions) resulting in a disruption of the functioning of repo market and monetary policy. In this context, even if the Liquidity Coverage Ratio (LCR) framework was adjusted, the potential disruption to the proper function of repo markets will remain, given its dependency of HQLA (e.g. in Europe).

In addition, the marginal risk weight add-on would unduly penalise banks which have a regulatory legislative requirement to hold liquid assets in sovereign exposures as in the case of many emerging market and developing economies' jurisdictions.

As mentioned by the Committee's findings the current level of banks' holdings of sovereign exposures reflects the many roles that sovereign exposures have in financial markets. Therefore, the IIF strongly believes that there is a case to continue to exempt sovereign exposures from the large exposures framework.

Furthermore, to apply Pillar 1 marginal risk weight add-on to address sovereign concentration risk has potentially material impact on liquidity, especially for countries that have a big network for subnational governments and PSEs that meet the support criteria. As highlighted in the paper, sovereign exposure also functions to support the liquidity requirement (e.g. HQLA). In managing concentration risk, it may compromise the composition and quality of liquid instruments held for the purpose of meeting liquidity requirements.

Additionally, and as previously discussed, financing of exports to high-risk jurisdictions can benefit from export finance support through ECAs. There are effects on any add-on, as sovereign deterioration (i.e. the sovereign exposure) could result in additional capital requirement, although the underlying exposure (the financing arrangement) cannot be re-priced to reflect that add-on. *Please refer to Questions 2, 3, 4 and 9 for the discussion of the impact of sovereign exposure for export finance.*

**Q10: What are current market practices related to haircuts of sovereign repo-style transactions? Do you believe that the current repo-style discretion to apply a haircut of zero should be removed from the credit mitigation framework?**

The IIF view is that the discretion to apply a haircut of zero under certain conditions for sovereign repo-style transactions should be preserved. Repos are typically short term, and therefore relatively lower risk. Additionally, revising the current rules may making the use of sovereign collateral less attractive to banks, potentially pushing them to hold lower quality collateral instead.

**Q11: Do you have any comments on the potential Pillar 2 guidance of sovereign exposures? Is there a need for additional guidance?**

We would recommend that if a guideline is to be established to cater for sovereign exposures, it should be sufficiently high level to be applicable across banks and jurisdictions rather than being overly prescriptive which would limit its applicability.

Some of the indicators listed (e.g. sovereign rating deterioration, political risk, macroeconomic indicators) are currently taken into account in banks' stress testing exercises and therefore might be redundant on a Pillar 2 basis. Additionally, for some banks it will be challenging to estimate the impact on funding costs and funding availability during sovereign distress.

**Q12: Do you have any comments on the potential Pillar 3 disclosure requirements for sovereign exposures? Is there a need for additional disclosure requirements?**

Generally, banks utilize their Pillar 1 data sets as the basis for the elaboration of their Pillar 3 disclosures. Therefore, it is our view that any additional disclosure requirement on sovereign risk should be driven by Pillar 1 data to ensure comparability among peers and to avoid misinterpretation of the information.

We have concerns on the workability of the templates in the Annex of the Discussion Paper, which require banks to disclose data that is currently not being produced. The additional requirements are (i) reporting by currency and (ii) extraction of the exposure and RWA related to sovereign trading positions from institutions' VaR models or STD market risk calculations. Generally, banks utilize their Pillar 1 calculations

The Discussion Paper proposes three new templates:

- Template 1 Exposures to sovereign entities – country breakdown
- Template 2 Exposures to sovereign entities – currency denomination breakdown
- Template 3 Exposures to sovereign entities – accounting classification breakdown

Firstly, the IIF considers that Template 1 would effectively result in disclosure of exposures by counterparty for central government and central banks. At present disclosures are not made by counterparty for performing exposures. The Committee should consider whether such disclosure would result in breaches of client privacy.

Secondly, as a matter of interpretation, we seek clarification on what material information would be provided through separate reporting of currency breakdown (Template 2) by the new sovereign exposure categorization. In its current draft form, it would not be possible to cross-refer Template 2 to Template 1.

Thirdly, the link between Template 3 and Template 1 would be very weak owing to different concepts used between regulatory and accounting classifications. The kind of data required to populate Template 3 would not exist in institutions' regulatory reporting systems. It would be more beneficial for the Committee to explore a form of reconciliation of the sovereign exposures with the institution's balance sheet.



Fourthly, in relation to the data breakdown required for banking book exposures in Templates 1 and 2, we question the rationale for disclosure of exposures both before and after credit risk mitigation, and the additional sub-division into on and off-balance sheet items. This kind of breakdown is disproportionate compared to any benefit that might arise from the disclosure.

Finally, for trading book disclosure, it is not clear how the Exposure and RWA measures should be defined. As market risk exposure nets across exposure classes and maturities, a stand-alone disclosure would be meaningless.

**Q13: Do you agree that home authorities of internationally active banks should be encouraged to recognize the prudential treatment of sovereign exposures applied by host authorities for subsidiaries?**

The IIF highlights that there is a misconception that home authorities of internationally active banks typically recognize the prudential treatment of sovereign exposures applied by host authorities for subsidiaries; in reality banks face different viewpoints from home authorities and host authorities. Although several of our members agree and encourage home authorities to recognize the prudential treatment of sovereign exposures applied by host authorities for subsidiaries, some see a valid justification for a different treatment, as described below.

Those that agree and encourage home authorities to recognize the prudential treatment of sovereign exposures applied by host authorities, work under the assumption that host regulators will ensure that their approach is most suitable and appropriate for their specific jurisdiction. In their view, to allow home authorities to deviate from host authorities would lead to an unlevel playing field between internationally active and domestic banks as well as result in confusion in the market as to the level of risk amongst international and domestic banks operating in a specific jurisdiction.

Some banks are of the view that host authorities for subsidiaries should not override the treatment of home authorities of internationally active banks, as this would result on discrepancies between the risk weights at consolidated level (i.e. internationally active banks have to calculate RWAs of sovereign exposures of subsidiaries under host authority's prudential treatment, and RWA of the same sovereign exposure under their home authority's prudential treatment).

We welcome a definition for reciprocity in this context to avoid subjectivity. In practice, banks may interpret reciprocity to mean that the same risk weights are applied in home and host countries, but it could also mean that the same capital charges apply or that capital charges in the host country are deductible in the home country. It would also be useful to clarify whether reciprocity should be applied to exposures at a standalone or at a consolidated level.

**Q14: Are any further revisions to the regulatory treatment of sovereign exposures needed?**

With respect to European regulations, we deem a specification for Sovereign Bonds with respect to the Definition of Default trigger related to the Sales of credit obligation with material loss (CRR Article 178(3)(c) and further specified in EBA Guidelines on Definition of Default) should be specified, creating a proper link and consistency between BCBS and EBA Regulation. Indeed, these exposures usually represent the big part of the Held to Collect and Sell portfolio (HTCS).

Indeed, Sovereign Bonds should be always excluded from the perimeter of application of this UTP trigger, due to the following peculiarities:

1. a Sovereign default is an event whose occurrence is based entirely on market/external information;
2. they are present in the banking book predominantly for reasons of liquidity/treasury management, so their sale would not be anyhow connected to a credit related reason.

Such an approach for Sovereign Bonds is considered also coherent with the possibility recognized Paragraph 42 of EBA GL: “Institutions may, in particular, consider the loss on the sale of credit obligations as non-credit related where the assets subject to the sale are publicly traded assets and measured at fair value.”