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Secretariat of the Basel Committee on Banking
Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org

Doc Ref: GARYH/#236816_V2
Your ref: Reg Treatment Sovereign Exposure
Direct ☎: 011 645-6708
E-✉: garyh@banking.org.za

Cc: SARB-banksup@resbank.co.za

Dear Sir/Madam

Re: **Discussion paper: Regulatory Treatment of Sovereign Exposures**

We thank you for the opportunity to provide comment on the Basel Committee on Banking Supervision (BCBS) discussion paper that looks at the treatment of exposures to Sovereigns.

We believe the discussion paper is a good summary of the sources and channels of sovereign risk in the banking system, the holistic role of sovereign exposures and the existing regulatory treatment of sovereign exposures. As such, any revising of the existing regulatory treatment entails a risk of having unintended consequences and it is recommended that an impact assessment is conducted prior to making any changes.

We note that the Committee recognises that the specific roles of sovereign exposures may vary across jurisdictions due to the heterogeneity in banks' business models, market structures and macro-financial balances.

In general:

- We are supportive of the differentiation between central banks, central government and other sovereign exposures and encourage the Committee to provide examples of subnational and public sector entities that satisfy the risk equivalence criterion for consideration as central government
- We do support the use of external ratings, but would recommend the introduction of a Standardised Credit Risk Assessment Approach (i.e. in line with the Bank asset class under the revised Standardised Approach contained in "Basel III: Finalising post-crisis reforms"). This would accommodate jurisdictions that do not allow the use of external ratings as well as subnational government and public sector exposures that are not externally rated. In terms of the granularity of the risk weight table, increased granularity could be accommodated when using external ratings. For a Standardised Credit Assessment Approach the granularity will have to be limited to avoid undue complexity.
- We would recommend that Sovereign bonds held for HQLA purposes should be subject to a 0% risk weight and be exempt from concentration risk assessment

- We do support risk weights that differentiate by at least: external rating agency ratings, local vs. foreign currency – where this may not be reflected in separate rating agency ratings, and entity type. We do prefer a more granular set, closer to that included in table 4.
- We acknowledge that the low default nature of sovereign exposures makes it difficult to model risk parameters (i.e. PDs and LGDs), but consider the removal of the Internal Ratings Based Approach in its entirety as unnecessary. The models employed by banks are equivalent to those employed by Rating Agencies in their rank ordering of sovereign entities. The issue lies with the calibration of the risk parameters and as such we wish to recommend the introduction of PD and LGD floors and/or ranges as means of ensuring appropriate capitalisation for the credit risk.
- Asset classification as set out in the document needs to be clarified in a “*developing economy scenario*” as:
 - We are not sure that the distinction between central bank and central Government is clear enough or if even necessary?
 - We would not recommend a distinction between central banks that target exchange rate stability vs. where this is not the case.
 - We do agree that there is a difference between local and foreign currency assets to central banks.

Please see our response to the specific questions below:

No.	Question	Response
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?	In the South African domestic market, there is a risk in illiquid syndicated or bilateral loans provided to state-owned enterprises (SOEs) entities supported by explicit financial guarantees from the sovereign.
Q2	Are there additional roles of sovereign exposures in financial markets and the broader economy that are of relevance to the prudential regulatory treatment of sovereign exposures?	In addition to tradable bonds and bilateral lending, contingent lending (Guarantees) assist in supporting entities such as Public-Sector Entities (PSEs) or Renewable Energy projects. There are also IPRE deals backed by government leases. We believe Export Credit Agencies (ECAs) represent another role of sovereign exposures in the financial markets. ECAs are critical in supporting export and infrastructure financing in high-risk

		jurisdictions. This effectively transforms the risk faced by banks in part or in whole (i.e. either through Transfer & Convertibility Risk cover or full Commercial Risk cover) to that of sovereign risk.
Q3	What are your views on the potential definition of sovereign exposures?	Agree with the addition of different sovereign entities into the definition. The term "support" needs to be defined more clearly, to incorporate the difference between implicit and explicit support. It would be beneficial if the definition of "other" sovereign entities has further clarity i.e. – specifically; does this include provincial Government and Public Sector Enterprises?
Q4	Do you agree that the definition of domestic sovereign exposures should be based on both the currency denomination of the exposure and the currency denomination of the funding? How would such a definition be operationalised in practice?	Agree, the concern is however that there will be an impact on both the operations and systems of all banks including source systems and risk consolidation engines. Funding sources are fungible particularly when a bank operates a central treasury function across multiple currencies, and as such is difficult to define domestic-currency sovereign based on the currency of the exposure as well as the funding. We recommend the definition of domestic-currency sovereign exposures be based on denomination of the exposure as well as the assertion that the bank has raised funding (through both capital and non-capital instruments) in same currency equal to or greater than the sovereign exposure in question. We believe this should adequately address any foreign exchange risk from such exposures.



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?	The ability to differentiate between a central government and central bank on domestic currency exposures is a concern. The “support criteria” needs to differentiate between implicit and explicit support.
Q6	Do you agree that capital requirements for sovereign exposures cannot be modelled robustly, and that such exposures should be subject to a standardised approach treatment as a result?	Although it may be difficult, we would like to draw a distinction between model development and calibration. In this respect we subscribe to the EBAs Guidelines on PD Estimation, LGD Estimation, and Treatment Defaulted Exposures in which it defines the two as follows: •Model development is the process that leads to risk differentiation. It is commonly referred to 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”. The models employed by banks can appropriately differentiate risk amongst various sovereign exposures as these models are equivalent to those employed by eligible External Credit Assessment Institutions (ECAIs). We note the



		Committee's continued use of ECAI ratings under the Standardised Approach and thus view the disallowances of the Internal Rating Based Approach as somewhat prejudicial. We think the use of IRB approach could be considered, but with a more focused calibration of the risk through the introduction of PD and LGD floors and/or ranges. We believe this approach to be consistent with the Committee's approach to low default portfolios, as per its recent publication "Basel III: Finalising post-crisis reforms".
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	•Design – Consider the difference between local-currency versus foreign-currency external ratings, especially where these differ. Also, the differentiation between liquid tradable exposures versus illiquid exposures can be considered. •Calibration – Existing default experience and loss rates from sovereign default studies can be used as benchmarks. •Risk Sensitivity – Support the introduction of more granular rating buckets, in particularly for non-investment grade exposures.
Q8	What role could specific non-rating indicators play in determining sovereign exposure risk weights in the potential standardised approach?	Type of product – the liquidity and tradability of an exposure may contribute in determining the risk-weighting of a product. For example, there may be more options for a bank in an event of negative risk mitigation or stress to manage a highly liquid sovereign bond exposure versus an illiquid bilateral loan to a sovereign.



		It would be good to get an understanding of how the Committee calibrated the proposed Risk Weights?
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?	It is important to consider the banking sovereign nexus when penalizing for concentration risk especially when the bank is acting as a shock absorber for sovereign stress. Consideration for developing markets is also important as there may only be one source of HQLA. In jurisdiction where banks run inherently higher concentration risks, the assessment of how to incorporate the risk should be carefully considered as to not over compensate in both the RWA add-on and a higher capital adequacy. We feel that the introduction of a marginal risk weight add-on approach for mitigating sovereign concentration risk could be problematic for international banking groups operating in emerging markets. This is due to the significant liquid asset and minimum cash reserving requirements imposed by these markets, many of whom are not yet compliant with the Committee's latest standards (e.g. Nigeria with 30% of local currency deposit base to be held in central government debt securities and an additional 22.5% to be placed with the Central Bank). The marginal risk weight add-on approach would lead to international banks reducing their "discretionary" exposures to central banks and central governments much of which is the form of FX hedges used by the central banks to manage their



		exchange rates in line with their monetary policy.
Q10	What are current market practices related to haircuts for 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 risk mitigation framework?	We do not see instances in which it would be appropriate to apply a zero % haircut, however, The South African Reserve Bank makes available a local currency repo facility collateralized by central government debt at a haircut of between 1% - 3.5%. The local interbank repo market applies no haircut when collateralized by local currency central government debt. This treatment varies across other emerging markets on the continent (e.g. Central Bank of Nigeria applies a haircut of between 3% - 5% whereas the Nigerian interbank market applies a haircut of between 10% - 20%). Thus we recommend that the Committee retain the national discretion to apply a haircut of zero for repo-style transactions given the varied approach across different markets and consequently the potential negative impact on the liquidity thereof.
Q11	Do you have any comments on the potential Pillar 2 guidance on sovereign exposures? Is there a need for additional guidance?	A standardised stress testing guidance note would be useful.
Q12	Do you have any comments on the potential Pillar 3 disclosure requirements for sovereign exposures? Is there a need for additional disclosure requirements?	We find the proposed add-on approach to deal with concentration risk concerns, the suggested Pillar 2 items and the suggested Pillar 3 disclosure requirements to be a good starting point for discussions on how to strengthen risk management and disclosure practices. We recommend the Committee provide additional clarity and guidance in respect of the Pillar 3 templates contained in the Committee's annex, particularly with



		respect to sovereign exposures held within Trading book. For example, is only the default risk charge for sovereign exposure in the trading book to be included in column f of template 1 and 2? How should long and short positions in sovereign debt across different maturities and different currencies be netted in column e of template 1 and 2? We believe the absence of the aforementioned clarity and guidance could lead to inconsistencies in the disclosure of sovereign exposures amongst banks and consequently misinterpretation by the market.
Q13	Do you agree that home authorities of internationally active banks should be encouraged to recognise the prudential treatment of sovereign exposures applied by host authorities for subsidiaries?	Agree, otherwise more than one approach would need to be considered. Home authorities' must recognise the prudential treatment of sovereign exposures applied by host authorities. To allow home authorities to deviate from host authorities would lead to an un-leveled 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.
Q14	Are any further revisions to the regulatory treatment of sovereign exposures needed?	Discussions will need to be held with the relevant sovereigns to consider this framework as well as the additional pricing stress this may have on their operations.



Thank you for taking our comments into consideration.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Gary Haylett', with a stylized flourish at the end.

Gary Haylett
GM, Prudential Division

