

March 9, 2018

Secretariat of the Basel Committee
on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel, Switzerland

Dear Basel Committee members:

Re: CBA¹ Comments on the BCBS Discussion paper: *The regulatory treatment of sovereign exposures*

Thank you for the opportunity to provide comments on the BCBS's discussion paper. *The regulatory treatment of sovereign exposures* ("discussion paper"). We recognize that the Committee has not reached a consensus on making any changes to the regulatory treatment of sovereign exposures at this time. Nevertheless, we appreciate the chance to review the ideas presented in the discussion paper and to offer our views, which we hope will be helpful in informing the Committee's longer-term thinking. We have included comments on key issues below and we have provided our responses to the questions posed in the discussion paper in the attached appendix.

Removal of the Internal-Ratings Based (IRB) approach for sovereign exposures

We disagree with the idea presented in the discussion paper to remove the IRB approach for sovereign exposures. While we acknowledge that there may be a relatively low number of default observations for sovereigns, this supports the fact that sovereign exposures are generally low risk. Our Advanced IRB (A-IRB) models have been designed and calibrated over several years, so it is not evident how a standardized approach (SA) will result in a better design or more accurate RWA outcomes. We also note that the Bank of Canada uses models to assign credit ratings to sovereigns². We are concerned that a move to an SA framework for sovereign exposures will result in a significant increase in capital that is not commensurate with the amount of risk. While highly rated sovereign exposures may see some RWA reduction, exposures to lower rated sovereigns will see a significant increase.

We also disagree with the alternative idea of retaining only the Foundation IRB approach. This will also negatively impact RWA since internal LGD estimates for sovereign exposures are

¹ The Canadian Bankers Association works on behalf of 62 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

² See staff discussion paper on Bank of Canada website: <http://www.bankofcanada.ca/2017/05/staff-discussion-paper-2017-7/>

currently lower than the prescribed 45% for many banks. We believe a required 45% LGD under the Foundation IRB approach severely penalizes sovereign exposures as this would require sovereign exposures to be treated as equivalent to unsecured corporate and bank exposures. This would occur regardless of whether the sovereign exposure was from the bank's home jurisdiction.

While we acknowledge the Committee's concern that sovereign exposures may be difficult to model given the lack of significant historical data relative to other asset classes, we believe that any changes to the capital requirements for sovereigns should be made in close consultation with industry, and backed by quantitative data and evidence. This is critical given the importance of sovereign exposures to banks' balance sheets and risk management tools.

Material changes in capital requirements related to sovereign exposures could also have a profound effect on the economy as governments often play a critical role in ensuring that there are cost-effective ways for current and prospective homeowners to finance their home purchases through various means, including providing insurance and guarantees on mortgages. Such insurance and guarantee programs are also important tools for banks to manage their balance sheets and overall risk.

With the above in mind, we believe that the A-IRB approach should be retained for sovereign exposures. We support the Committee's view that an important consideration should be the impact that any change would have on the current capital requirements for sovereign exposures. Furthermore, we note that banks must maintain a stock of High Quality Liquid Assets to meet LCR and NSFR requirements and this includes investing in sovereign and central bank debt securities. Any increase in capital requirements for sovereigns would conflict with this obligation. We therefore recommend that any changes that may be considered for the regulatory treatment of sovereign exposures be reviewed in a holistic manner.

Treatment of sovereign exposures under the market risk framework

We would also like to reiterate our concerns regarding the treatment for sovereign exposures in the trading book under the revised market risk framework³. In particular, the 3 bps floor for sovereign exposures is punitive, and is inconsistent with standardized approach risk weights. In addition, it is unclear what the impact of removing sovereign exposures for the models based approaches would be for the trading book.

Marginal risk weight add-ons to mitigate concentration risk

We disagree with the idea of adding incremental risk weight add-ons for sovereign exposures in relation to concentration risk. We believe that this is too blunt of a tool that oversimplifies the modelling of concentration risk and will have material implications for how banks manage their risks and balance sheets. We also feel this will ultimately increase the cost of borrowing to end users of credit.

In relation to Tables 7 & 8 in the discussion paper, we are also concerned about the implications for banks that operate in countries with government insured mortgage programs. Such banks will have relatively higher sovereign exposures and would therefore be subject to higher marginal risk weight add-ons as a result. This would unfairly penalize such banks and conflict with the objective of government support programs for home purchases. Sovereign exposures are different from other asset classes as they not only have financial and economic impacts, but also social and political implications (i.e. financing government support programs for home

³ BCBS minimum capital requirements for market risk (2016).

ownership). For example, Canadian banks have large government-insured home mortgage exposures through the Canada Mortgage and Housing Corporation.

If further action is required by jurisdictions, we suggest as one alternative that concentration risk can be managed through Pillar 2 treatment, based on specific circumstances and other qualitative factors applicable at the time, rather than applying predetermined risk weight add-on factors.

Pillar 2 – Stress testing

We are concerned about the potential heightened capital impact under stress based on ideas that are presented in the discussion paper (e.g. removal of the IRB approach for sovereigns, non-zero risk weights under the SA, etc.). We prefer consistency in stress testing approaches across jurisdictions in relation to sovereign exposures. We also suggest that decisions on stress testing be made by the BCBS Working Group on Stress Testing and consider the consultative document *Stress testing principles* that was issued on December 20, 2017. It is important to ensure that principles-based guidance that exists does not conflict with the ideas presented in the discussion paper.

In conclusion, we believe there are some positive aspects of the discussion paper that may warrant further discussion to improve the current A-IRB approach and ensure a level playing field across jurisdictions. For example, we note that some parts of the discussion paper address certain shortcomings of the current A-IRB approach with respect to:

- a. Differentiated risk or relative risk ranking of sovereign-related entities.
- b. Different home-host capital requirements which create an uneven playing field for international subsidiaries.
- c. Eliminating the redundancy that local currency exposure be funded in local currency.

However, we also find that other areas of concern are not addressed (e.g. foreign versus domestic ownership of debt in relation to selective default treatment within dollarized economies or monetary unions). Furthermore, we believe that some other ideas that are presented are impractical or could negate sovereign policy (e.g. concentration risk add-ons), or are too simplistic (i.e. no demonstrated evidence that A-IRB models are not robust and, by extension, no evidence that a SA is a more accurate and risk-sensitive approach).

We also do not see how a broader transition to a SA will improve capital management for banks generally or how such recommendations can be reconciled with a sovereign's prerogative to manage its monetary and fiscal policies, and, ultimately, to act as a lender of last resort.

Thank you in advance for considering our comments. We would be pleased to discuss our submission at your convenience.

Sincerely,



Attachment

cc: Catherine Girouard, Director, Bank Capital, Capital Division, OSFI

**CBA Comments on BCBS Discussion paper
'The regulatory treatment of sovereign exposures'**

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Overall CBA Comments and Key Issues	
Please refer to cover letter	
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? (p. 11)	
No comments	
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? (p. 17)	
In addition to being a source of liquidity for banks, sovereign debt is an important part of balance sheet management tools including for asset liability/interest rate risk management, maintaining net interest margin, etc. Any increase in capital requirements for sovereign exposures would need to be carefully calibrated and weighed against the potential cost to the economy and other consequential effects including higher borrowing costs for consumers, loss of an important risk mitigant for banks, as well as lower revenue for governments, etc.	
Q3: What are your views on the ideas set out above related to the definition of sovereign exposures? (p. 24)	
We believe the suggested definitions are helpful and provide clarity. We support recognizing different risks associated with central banks and sovereigns, their respective PSEs (i.e. those that have full faith and credit of the sovereign versus those that do not), and their sub-sovereigns that have taxing authority versus those that do not. Validating and establishing criteria to assign those categories and ensuring consistency across jurisdictions may prove to be more problematic. On p.23 of the discussion paper, the Committee notes that "... the current Basel II standardised approach for credit risk refers to claims on	

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"sovereigns", "central banks", and "non-central government public sector entities (PSEs)" in a relatively high-level manner. Exposures to sovereigns and central banks receive a distinct treatment. In some cases, exposures to non-central government PSEs can be treated as an exposure to the sovereign instead of as a bank exposure".

With the expanded definition of PSE put forth by the Committee, is the intent that "Government Sponsored Enterprises" ("GSE") in the US, such as Fannie Mae, Freddie Mac, Federal Home Loan Bank System, and the Farm Credit System will be captured? These entities benefit from the implicit (not explicit) support of the US Government.

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? (p. 24)

Sovereign risk is the sovereign (or government) obligor's likelihood of defaulting on its financial obligations. Domestic sovereign exposures can be denominated and funded either in domestic or foreign currency. To define domestic sovereign exposures and funding by currency denomination is to identify a sovereign's financial capability to handle default in different currencies.

If the domestic sovereign exposure and funding are in domestic currency, a sovereign can simply pay off its principal and interest fully and on time since it has the taxing and monetary power to do so. This supports the current preferential risk weight provided for sovereign exposures denominated and funded in domestic currency.

If the domestic sovereign exposures are in foreign currencies, a sovereign will have to rely on her foreign reserves to service her external debt service obligations. Failure to do so will result in default, i.e. (1) accumulation of arrearages; (2) restructuring or rolling over of debt; or (3) inability to meet its external debt service obligations (actual default).

The IRB approach can be used to operationalize the above definition. This can be complemented by stress testing under Pillar 2 to identify and forecast macroeconomic and bank vulnerabilities.

Given that foreign exchange risk can be hedged and in most cases is hedged, the currency denomination of the sovereign exposure should not be factored into its risk measurement. Distinguishing between different source currencies to calculate RWA for sovereign exposures would be inconsistent with the current RWA calculation of exposures to banks, corporates, and retail portfolios.

Our experience is that currency, while important, is less of an issue than foreign ownership of a debt. The concept of selective default is not

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found in the discussion paper but is quite relevant to our sovereign default experience. Governments generally seek to avoid socializing their defaults and will generally target restructuring their external debt first. For dollarized economies (e.g. El Salvador or Panama), this currency issue becomes quite relevant as would the treatment of the Euro within the Eurozone (e.g. Greece).

Lastly but not least, the operational issue about local currency exposure funded in local currency is not new and is a legacy from Basel 1, introduced under far less sophisticated capital rules to address foreign exchange mismatch and cross-border risk. As noted in the discussion paper, funding is fungible and we believe there are now more robust risk controls and capital measurement for foreign exchange risk in our balance sheet. The funding match requirement has become obsolete and should be removed.

Q5: Do you agree with the potential relative rank ordering of different sovereign entities and with the principle of a potential risk equivalence criterion for treating certain non-central government exposures as central government exposures? Do you have any comments on the criterion? (p. 25)

We agree with the potential relative rank ordering of different sovereign entities and with the possibility to treat certain non-central government exposures as central government exposures. The ideas underlying the criterion are reasonable, but more work is required to assess if the wording is clear enough to ensure consistent interpretation.

Autonomy criteria: How would banks be able to assess this? In federal systems, divisions of powers and jurisdictional authority are embedded in the Constitution and subject to complex legal interpretations. Unless the regulator provides a 'pre-approved equivalence list' it would be very difficult and/or very costly for banks to conduct such an assessment.

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? (p. 25)

We disagree. Our PD models perform well against external benchmarks (ratings, CDS, etc). The concern may have more to do with the relatively low number of default observations, and some broad dispersions in LGD outcomes. We do not believe, however, that the standardized approach can bridge this gap and we would underscore that the A-IRB approach is more risk sensitive. This is a systemic issue and we do not believe that a standardized approach, per se, is any more robust than internal models.

Our A-IRB models have been designed and calibrated over several years, so it is not evident how a standardized approach will result in a

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better design or more accurate RWA outcomes. We believe that external ratings should continue to be available for use. An internal governance process may be put in place to validate the ratings obtained.

To maintain consistency in approaches available to all other portfolios, we believe that a modelled approach should be permitted for sovereign exposures. The low frequency of defaults does not suggest that models are not robust but simply means that a low probability of default should apply.

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? (p. 28)

If the standardized approach were to become the only option available for sovereign exposures, we suggest that a more risk sensitive standardized framework should be adopted. This would also be consistent with the objectives of the recently finalized Basel III reforms. We would underscore that neither a flat risk weight for all sovereign exposures or requiring additional data (e.g. macroeconomic variables, fiscal variables and/or credit aggregates) is realistic or operationally feasible in the latter case.

With respect to Table 6 in the discussion paper, we disagree with the simplicity of the rating buckets presented and the punitive risk weights (even if indicative) relative to both the implied risk both in absolute terms (our actual loan loss experience in sovereign defaults) and in relative terms (i.e. RWA for a similar rated corporate). Moreover, we note that unrated sovereigns are not indicative of risk but rather whether they have a need to access foreign capital markets.

The Table 6 calibrations should also not distinguish between different source currencies given that foreign exchange risk can be hedged and in most cases is hedged. As the Committee notes, funding sources are also fungible and should not be linked to a specific exposure.

Notwithstanding this, we also find that the additional RW%s for foreign-currency exposures are too punitive by applying an additional ~10% RW for AAA to A- rated and an additional ~45% RW for BBB-rated sovereign exposures denominated in foreign currencies. As a reference point, the SA-CCR only applies an additional 4% supervisory factor for the foreign exchange asset class.

With respect to "other sovereign entities" in Table 6, we believe that having only 3 buckets is not sufficient to reflect comparable risks. As currently proposed, we feel it is far too punitive to risk weight an "other sovereign entity" with a AAA rating at 25% compared to an entity with

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an A- rating, which is also assigned a 25% risk weight.

We believe that any continued discussion on this topic should incorporate a more granular look-up table (i.e. more rating buckets) such that sovereigns that do not have monetary policy centred on the exchange rate do not get penalized with extremely high risk weights. We believe this is the current deficiency in the suggested approach.

Q8: What role could specific non-rating indicators play in determining sovereign exposure risk weights in the potential standardised approach? (p. 28)

We disagree with the proposed approach. We suggest that non-rating indicators not be considered in any final recommendations as they are operationally challenging to implement and costly.

We are not aware that there is strong evidence that the macro indicators typically used are good early warning indicators of sovereign defaults.

We would like to highlight the difference between sovereign debt ratings and country risk ratings, and why we believe that the latter are more informative/meaningful for internal purposes. Non-rating indicators such as macroeconomic, fiscal, social, and credit metrics are already inputs into our country rating models and thus are not needed in determining 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? (p. 30)

We disagree with the proposed approach as we believe that marginal risk weight add-ons are a very blunt tool for mitigating concentration risk. The proposed RW%s in Table 7 of the discussion paper will likely add significant costs to banks. There are too many variables and unknowns for sovereign exposures to assign a priori Pillar 1 marginal RW%s. As the Committee acknowledges that the frequency of sovereign defaults is rare and data is difficult to obtain, we recommend a more nuanced approach through Pillar 2 in order to consider the economics, market environment, political context, etc. Table 7 also does not distinguish the marginal risk-weights by the credit quality of the sovereigns, which we believe is an oversimplification.

We also believe that a marginal risk-weight add-on for sovereign concentration could essentially amount to a capital tax on excess liquidity

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that a bank may have little ability to control, and potentially and deliberately be driven by the sovereign's own monetary or fiscal policies. This concept could become problematic. We are also concerned that any additional capital requirements will make it more difficult to meet LCR and NSFR requirements, as sovereign bonds are currently the highest category of HQLA without haircuts.

If further action is required by jurisdictions, we suggest that the Committee consider a Pillar 2 approach as articulated in our cover letter. Another alternative may be a modification to the large exposure framework to include sovereign exposures possibly at a higher threshold (above the current 25% of a bank's Tier 1 capital) instead of attempting to address concentration risk in Basel III Pillar 1 by increasing capital requirements.

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? (p. 30)

We are not in favor of the removal of the allowed zero percent haircut for sovereign repo-style transactions. The repo-market itself is very liquid and most banks have haircut thresholds based on their internal assessment of the counterparties.

We strongly support the position of keeping the home sovereign as a core market participant (zero risk weight), zero risk weight and CVA for exposure to the home sovereign in local currency, and zero haircuts for SFT.

Q11. Do you have any comments on the potential Pillar 2 guidance on sovereign exposures? Is there a need for additional guidance? (p. 34)

While we welcome Pillar 2 guidance, we believe our counterparty credit risk assessment processes already reflect many of the recommendations. We also question the basis of having a formal Pillar 2 monitoring when Pillar 1 treatment is already in place.

Stress testing

In our view, the ideas suggested may be applicable to some banks that are either operating or have significant exposures in more risky countries. However, the ideas are not necessarily relevant or applicable to all banks. From the perspective of a bank that is largely operating and invested in triple-A and double-A rated countries, it is hard to conceive of the context in which the suggestions should be implemented. It is the Risk Manager's mandate to review risk reports, matrices, market movements and events, and through such review, the Risk Manager

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monitors early signs of “stress” of various positions, including sovereign exposures.

Additionally, it is unclear if the ideas presented refer to a specific category of stress test, such as, for instance, a stress test for capital adequacy purposes, or a reverse stress test. The suggestions also place the burden on the risk manager to demonstrate the non-practicality or non-applicability of simulating such distress.

We would like to caution that the ideas in other sections such as removal of the IRB approach and the introduction of non-zero risk weights for the standardized approach could have heightened capital impacts under stress. Domestic banks generally have a stabilizing effect during periods of sovereign-stress as they will (be asked to) invest in domestic sovereign bonds during times of crisis. Any regulation that indiscriminately caps exposure to domestic sovereigns and/or translates into higher risk weights and higher capital charges for domestic banks, would stress sovereign financing conditions precisely at the time when fiscal space is needed. This could lead to potential cliff-edge/spill over type scenarios.

Overall, we are concerned that the suggestions in the discussion paper move in the opposite direction to the views expressed by the BCBS in their consultative document “Stress testing principles” (December 2017). For example, the Committee notes in the consultative document that they have *“tried to exclude from the principles [...] specific issues of detail in favour of more generally applicable concepts.”* The consultative document is also presented as an improvement over the *“current stress testing principles [that] are detailed and may not be applicable to all banks.”*

Q12: Do you have any comments on the potential Pillar 3 disclosure requirements for sovereign exposures? Is there a need for additional disclosure requirements? (p. 34)

We are satisfied with current disclosure requirements. We see no additional benefit to changing these disclosures.

We believe the disclosure requirements provided in the Annex are too granular. Banks already disclose a sufficient level of information related to sovereign exposures including EAD, and RWA by PD bands. The additional stratification proposed will result in a significant amount of effort without much added benefit.

We are also concerned with the recommendation included on Template 1:

(a) Defined as jurisdictions with non-negligible holdings of sovereign exposures. Banks choosing not to disclose exposures to specific jurisdictions

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are required to explain why they consider such information to not be meaningful to users, including a list of jurisdictions not disclosed separately, and the aggregate exposure amount (separately for banking and trading exposures) that these jurisdictions represent.

If required, we believe the banks should only disclose material sovereign jurisdictions holdings and allow grouping of other jurisdictions without having to provide an individual list of jurisdictions. This additional information will not provide any insights to stakeholders who are more concerned with material exposures.

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? (p. 35)

We agree. Local subsidiaries should be able to compete on a level-playing field with their local bank competitors.

Q14: Are any further revisions to the regulatory treatment of sovereign exposures needed? (p. 35)

No comments

Annex: Potential Pillar 3 templates for sovereign exposures (p. 39)

Template 1: Exposures to sovereign entities – country breakdown (p. 39)

No comments

Template 2: Exposures to sovereign entities – currency denomination breakdown (p. 40)

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No comments
Template 3: Exposures to sovereign entities – accounting classification breakdown (p. 41)
Please confirm if columns (a) – (f) requests both on- and off- balance sheet amounts (as in Templates 1 and 2). How does the Committee view the reconciliation between Templates 1 or 2 to Template 3? Footnote (b) currently states "Net of provisions". To be clear, we believe that it should read "Net of specific/Stage 3 provisions".