



THE CENTRAL BANK OF HUNGARY

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Response to discussion paper of the Basel Committee on the regulatory treatment of sovereign exposures

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?

To have a clear account of sovereign related risks for which the regulatory options are investigated it would be meaningful to distinguish the (1) sovereign risk as results of the insolvency and default of a certain country and (2) sovereign risk associated with the increase of probability of default of a certain country that leads to a relatively moderate depreciation of the sovereign assets. Risk buffers are more suitable to handle the second type of sovereign risk, but the moderate depreciation in the value of the sovereign assets does not fully represent problems related to the sovereign-bank nexus. In contrast, capital requirements would be a less efficient option against the first sovereign risk type, which assumes the suspension of sovereign debt repayments at least partially (technical insolvency). Capital requirements adequate for absorbing a considerable amount of losses related to actual sovereign insolvency would have to be determined at inefficiently high levels, therefore, the risks of the sovereign-bank nexus are advisable to be mitigated more effectively by other measures. E.g. strengthening the supervisory mandates to effectively monitor and control the sovereign risk management practices through Pillar 2 dialogue which enables the supervisor to target the most vulnerable institutions more effectively. Also improving the sustainability of the sovereign budget could be better suited for this task.

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?

Sovereign assets have several broad-based roles:

- They serve as high-quality collateral critical to many transactions, including those in private repo, central bank repo, and OTC derivatives.

- Banks manage liquidity and solvency risks with sovereign assets and this asset class plays a key role in banks' day-to-day asset-liability management.
- At times of stress when the sovereign is not affected severely, banks can also temporarily increase safe asset allocations to raise capital ratios and access secured funding markets, or to counterbalance losses to stabilize income.
- Some banks act as primary dealers and market makers for government bonds and support secondary market liquidity for such bonds through active trading.

Q3. What are your views on the ideas set out above related to the definition of sovereign exposures?

The Magyar Nemzeti Bank (MNB, the Central Bank of Hungary) supports the further investigation of concepts and criteria of defining the set of sovereign entities outlined in the DP.

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?

The MNB agrees with the distinct treatment of sovereign exposures denominated in domestic currency compared to other currency denominations, based on their different credit risk characteristics. As the LCR regulation already requires the supervisory operationalization of the mismatches in currency denomination of funding and requires their management, it is a practically feasible option.

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?

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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?

The MNB agrees with the assessment that capital requirements for sovereign exposures is a challenging task to model robustly. However, we believe that the revision of the standardised approach (SA) regulation is also problematic. See our discussion on the appropriateness of the SA regulation in Q7.

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 MNB supports the current (status quo) Pillar 1 regulation of sovereign exposures, especially as within the SA approach, zero risk weights for sovereign exposures denominated and funded in local currency are set in a directly applicable EU regulation. This distinguished treatment of sovereign exposures originated by a particular government (primary importance should be attributed to sovereign exposures vis-à-vis the home jurisdiction) and denominated in its currency is justified by the key economic functions played by these exposures and their quasi safe asset quality.

In our view, the possible revisions of the SA regulation outlined in the DP would not provide an effective and efficient regulatory solution for treating the banking sector's credit risks related to sovereign exposures, while they may contribute to a false sense of security of those authorities and agencies, e.g. the fiscal authority, which could effectively mitigate the risks related to feedback loops between banks and sovereigns.

A comprehensive and holistic analysis should expand on the arguments drafted in the Discussion Paper:

- The revision of the SA approach through assigning positive risk weights to the domestic central government exposures may have significantly different effects on banking operations (e.g. on risk management and through the capital cost of high quality liquid assets). The MNB has concerns about the disrupted functioning of interbank markets and central bank operations potentially caused by these regulatory changes.
- The possible revisions may not be adequate to prevent the risks stemming from bank-sovereign feedback loops. It should be noted that increased capital requirements via Pillar 1 regulation could not efficiently strike the right balance between strengthened loss absorbency and acceptable increase in own funds requirement. The SA approach for credit risk assumes well diversified portfolios, and cannot be applied against losses on the highly concentrated exposures of the domestic sovereign. Arguably, in general, own funds requirements as proposed in the DP would not be able to prevent the insolvency of credit institutions in meaningful sovereign stress, nor would it considerably isolate the banking system from the effects of overall economic downturn.
- Supposedly biased investment incentives originating from the preferential treatment of the domestic central government exposures or from the moral suasion of the domestic government and authorities may not be effectively mitigated by positive risk weights. The liquidity requirements, namely the LCR, where the holding of a considerable amount of HQLA is required and rationales for the home bias in investment decisions independent from the regulatory treatment can have a significant effect on the holding of sovereign portfolios as well.
- From a broader point of view, there are relevant macro-financial scenarios where it may be beneficial to allow the domestic financial sector to function as a stabilizing sector by maintaining demand for domestic sovereign bonds; moreover, sovereign exposures can

have a stabilizing effect on the banking sector as well. The beneficial outcome of these scenarios could be impeded by nonzero risk weights. On top of that, the greater international diversification of investors financing the sovereign and the greater diversification of government bond portfolios of credit institutions could significantly increase external vulnerabilities both for the sovereign and banks as well.

- Any revision of the SA approach and the system of risk weights should be consistent across exposures, thus central government exposures should bear the lowest RWs.
- Although out of the reach of the DP, more efficient risk mitigation can be provided to sovereign risks by strengthening the supervisory and resolution mechanism and institutions, and promoting fiscal sustainability.

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

The MNB does not support a mechanistic overreliance on external credit ratings. However, in contrast to the DP's conclusion, in our view this does not imply that the ideal regulatory solution is to supplement the SA approach with due diligence demonstrated to supervisors on the part of the institutions (here a reference to the challenges of the robust modelling of sovereign risk faced by credit institutions can be made among other concerns). Instead this means competent authorities should use model based, quantitative (whereas non-rating indicators and other early warning indicators of potential fiscal stress are observed), and qualitative assessment to supervise institutional risk management practices, which is not feasible to transpose into a Pillar 1 regulation.

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 MNB does not support the concept of marginal risk weight add-ons. This approach entails the same problems outlined in our response to Q7 and elsewhere above. Moreover, by assigning higher risk weights as a function of concentration, it establishes a more asymmetric treatment of national financial systems depending on their need to use domestic central government securities to function efficiently. At least domestic central government bonds denominated in local currency should be exempted from any concentration based capital requirement framework. The discussion on design and granularity once again does not take into account the fact that imposing the same concentration based capital requirements on two economies facing different characteristics on the demand and supply sides of the government bond markets or in the availability of HQLA can have significantly different consequences.

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?

In the collateral management of the MNB¹, the portfolio of the client's collateralized credit transaction is secured by the securities portfolio pledged for the MNB. Haircut is an effective risk management tool used by the MNB for collateral valuation. The applied haircut to sovereigns is based on the time to maturity, the type of interest paid (fixed, floating rate, zero coupon bonds), the liquidity and the denomination of the security (HUF or foreign currency-denominated securities). The lowest haircut applied by MNB is 0.5% to the sovereigns. Concerning the issuer, the MNB accepts only government securities issued by the Hungarian Government as collateral.

Due to the specificities of the Hungarian securities market, the government securities market has a specific and significant role in the repo-style transactions of credit institutions. The current market practices related to haircuts applied to government bonds in repo-style transactions vary substantially among Hungarian credit institutions. However, this variability in the determination of haircuts depends on a multitude of risk factors, e.g. the denomination of the sovereign securities, their maturity (shorter maturities with lower haircut) and their interest rate (fix / floating, the latter may lead to lower haircuts), etc.

Overall in our view the applicability of zero risk weight should be left with the counterparties and no change in the regulatory framework should be made. Based on the materiality of the repo markets in different jurisdictions such changes could entail unwelcome and harmful effects.

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

The MNB's view on this issue is that Pillar 2 guidance is more suitable than the possible Pillar 1 changes outlined in the DP, especially because Pillar 2 is more suitable to cater for bank-specific and jurisdiction-specific characteristics. Further investigation of stress testing and SREP guidance for sovereign risks may be a way forward, although this is already provided for by the Pillar 2 framework and as a consequence the evaluation of sovereign related risks through Pillar 2 is a supervisory practice already present in various jurisdictions.

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

Regarding the need for additional disclosure requirements on sovereign exposures, it could be beneficial to develop a thematic template of disclosure based on country, currency and accounting valuation breakdowns.

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?

¹ <http://www.mnb.hu/letoltes/risk-management-parameters-applied-to-eligible-collateral-accepted-by-the-mnb-from-11-july-2016.pdf>

The MNB agrees that home authorities of internationally active banks should be encouraged to recognize the prudential treatment of sovereign exposures applied by host authorities for subsidiaries due to the country specific characteristic of the sovereign risks.

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

We believe – based on the arguments above – that apart from the proposals the MNB highlighted above as worthy for more in-depth investigation, no further revisions to the regulatory treatment of sovereign exposures are needed.