

Secretariat of the Basel Committee on
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Credit Suisse response to the Discussion Paper on 'The regulatory treatment of sovereign exposures' (BCBS d425)

Credit Suisse Group AG (CS) would like to thank the Basel Committee on Banking Supervision (BCBS or Committee) for the opportunity to comment on the Discussion Paper 'The regulatory treatment of sovereign exposures' (BCBS d425 or Discussion Paper).

In response to the financial crisis, the BCBS has introduced a range of regulatory reforms. These have included the introduction of bail-in instruments, revised capital floors, a leverage ratio, a liquidity coverage ratio and the net stable funding ratio. CS would agree with the Committee that these reforms can potentially mitigate the impact of sovereign defaults on banks and the impact of bank defaults on sovereigns. As such, CS believes the Committee should fully assess the impact and effectiveness of these reforms once implemented, before making further changes to the treatment of sovereign exposures, and only publish a revised discussion paper once this analysis has been completed.

Definition of sovereign entities

CS supports the Committee's efforts to provide a more robust definition of the term 'sovereign entity'. However, we are concerned the revised definitions would still require banks to apply a certain amount of judgment that could potentially lead to divergence across banks. A more consistent treatment of sovereign entities could be achieved by centrally compiling and publishing a comprehensive list of sovereign entities and the relevant sub-categories.

Modelling of sovereign exposures and capital requirements

CS acknowledges the low default nature of sovereign exposures imposes challenges for the development of internal models. However, we believe internal models can be developed that effectively and consistently differentiate risk. These models are also more risk sensitive than a standardised approach. As such, CS is not supportive of the proposal to disallow Advanced and Foundation Internal Rating Based (A-IRB & FIRB) models for the sovereign asset class.

Standardised risk-weights

We agree with the Committee's proposal to align standardised risk-weights with the revised definitions of sovereign entities. The Committee should however consider retaining a national discretion whereby certain domestic sovereign exposures have lower risk-weights.

We do not believe the recalibration of the risk weights should result in higher capital requirements for banks. Therefore, any recalibration should reflect the full impact of the potential revisions of the IRB and standardised approaches that are suggested in the discussion paper.

Large exposure limits

We disagree with the proposal to include sovereign exposures into the calculation of the large exposure limits. The recently revised large exposure framework introduces a mandatory substitution approach, according to which collateralized exposures must be attributed to the collateral provider, rather than the counterparty of the instrument. The acceptance of sovereign collateral would therefore result in significant large exposures against sovereign entities. We are concerned that the proposals could force banks to reject certain sovereign securities as collateral and to request other, potentially lower quality collateral instead. This would have negative implications for the risk management of banks as well as for the liquidity of the sovereign debt markets at a macroeconomic level.

Pillar 2 and Pillar 3 proposals

We would ask the BCBS to reconsider the proposed changes to the Pillar 2 and Pillar 3 requirements for sovereign exposures. We do not believe the proposed changes to the Pillar 2 requirements are a material improvement on current regulation. As with other risk types there are already sufficient monitoring and stress testing tools for sovereign exposures.

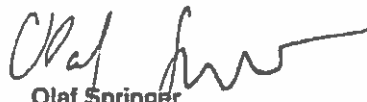
With regards to the proposed disclosures for sovereign exposures, we believe these go beyond the proposed revisions to the Pillar 1 treatment of sovereign exposures and do not necessarily relate to those requirements. It is our view that any proposed disclosure requirements should be directly linked to the underpinning Pillar 1 principles and supplement, rather than extend, this guidance.

Credit Suisse's detailed responses to the individual questions in the Discussion Paper are reproduced in the appendix to this letter.

Yours sincerely,



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Appendix

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?

We generally agree with the description of sources and channels of sovereign risks set out in the Discussion Paper and consider the Committee's analysis to be thorough and comprehensive.

However, we note that the statistical data provided in Graph 1 'Frequency of Sovereign Defaults' and Table 1 'Frequency of sovereign default crises and other economic crises in OECD and advanced economies' highlights that sovereign defaults are rare events and that the frequency of sovereign defaults has been continuously decreasing in recent history.

The Discussion Paper states that the statistical evidence provided may be incomplete, because the Greek sovereign debt crisis is not included in the data material analysed by the BCBS. In our view, the Greek debt crisis was the consequence of a set of particular circumstances including Greece's membership in the Euro monetary system, which limited its ability to implement monetary policy measures to reduce the national debt burden. For this reason, we are not convinced that inclusion of the Greek sovereign debt crisis in the BCBS's statistical analysis would necessarily change the picture of a declining frequency of sovereign defaults as conveyed in the graphs and tables in the Discussion Paper.

Moreover, the Discussion Paper mentions that many of the measures that have been implemented in the aftermath of the global financial crisis help to mitigate directly or indirectly a bank's sovereign risk exposure. Those measures include among others the implementation of too-big-to-fail regimes and the associated issuance of bail-in instruments, revised capital floors, the leverage ratio framework, the liquidity coverage ratio and the net stable funding ratio. Most regulators have also started to include sovereign defaults into their stress test scenarios. We agree with the Committee's observation and believe that those measures will help to reduce the risk that a sovereign default could trigger bank defaults and vice versa.

In light of the broad range of recently implemented regulatory measures and the encouraging statistical data, we wonder whether the Committee should first observe a monitoring period during which it assesses how the revised regulatory framework affects banks' exposures to sovereign risks and whether there is a need for further regulatory change with respect to those exposures.

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?

We agree with the Committee's theoretical description of the roles of sovereign exposures in financial markets and the broader economy. However, we believe that the BCBS analysis should be extended to include an investigation of the role of export credit agencies and sovereign guarantees of export finance. For further information on this matter, we refer to the IIF industry comment letter, which analyses the role of export financing in its responses to questions 2, 3, 4, 5 and 9 and recommends that the Committee clarifies that export guarantees should be treated as sovereign exposures.

Q3. What are your views on the potential definition of sovereign exposures?

The BCBS document 'Basel III: Finalising post-crisis reforms' (BCBS d424) refers to 'sovereigns', 'central banks' and 'public sector entities' without defining those terms. The Discussion Paper proposes to amend the terminology to 'central governments', 'central banks' and 'other sovereign entities' and to provide a definition for each of the revised categories. The document categorizes 'other sovereign entities' further into 'subnational governments' and 'public sector entities' for each of which it provides an extensive definition.

We are concerned that application of these definitions imposes a significant operational burden on banks. In particular, the definition of 'other sovereign entities' requires (a) in-depth legal knowledge of the relevant jurisdictions which banks would need to obtain from external resources and (b) even after the necessary legal knowledge has been obtained, a significant degree of judgment. We see therefore the risk that banks might come to different conclusions as to how an 'other sovereign entity' should be classified and that they might apply a diverging regulatory treatment to such an entity. We are also concerned that the risk of divergent assessments might cause some local supervisors to impose their own judgment on banks and introduce supervisory add-ons relating to particular sovereign exposures. Any such action would increase the risk of regional divergence and impair the comparability of the regulatory treatment of banks in different regions.

To allay these concerns, we suggest in a first step that the BCBS aligns the categories and definitions of sovereign exposures with those in the IMF's Government Finance Statistics Manual¹. The manual distinguishes between General Government and Public Corporations and provides further sub-categories for both items. An alignment between the BCBS and IMF definitions would base the BCBS proposals on long-established definitions that are well-understood and applied in the industry. This would eliminate the need for additional interpretations and judgment calls under a new set of BCBS definitions, thereby ensuring global consistency and a level-playing field across jurisdictions. The use of joint definitions would also reduce the risk of unintentional inconsistencies between the BCBS and the IMF frameworks.

We believe that our recommendation provides more robust definitions than the categorisations set out in the discussion paper. However, if adopted in isolation, it would still require banks to make difficult judgment calls potentially leading to divergence across the industry. This issue could be avoided if the onus is shifted from the banks to the BIS and the BIS determines centrally into which sovereign category a particular entity belongs as it is in a much better position to do so. Therefore, we suggest that the BIS leverage its own economic staff and IMF expertise to develop a central register of entities that meet the sovereign entity definitions. The BIS would then publish the list on its website and update it where necessary. As a result, this would reduce the operational burden and eliminate diverging views across banks while substantially improving comparability across the industry. The proposal is also aligned with the BIS's recent announcement around a closer collaboration with the IMF particularly in the context of implementing the post-crisis financial reforms².

The work of the BIS in this area could be supported by the work of national supervisors, which have the necessary understanding of the legal requirements and other specific circumstances in their region. The involvement of national supervisors would therefore help to ensure global consistency in the application of the definitions. We note that the Committee already applies a similar concept in section 10.1 of the draft 'Instructions for Basel III monitoring', when it states that for the purpose of the data collection exercise, national authorities will provide guidance on how to apply the equivalence criteria, especially which subnational governments are deemed equivalent based on criteria (a) and (b).

¹ <https://www.imf.org/external/Pubs/FT/GFS/Manual/2014/gfsfinal.pdf>

² <https://www.bis.org/press/p180209a.htm>

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?

Paragraph 8 of BCBS d424 provides national discretion to apply a lower risk weight to banks' exposures to their sovereign (or central bank) of incorporation denominated in domestic currency and funded in that currency. The Discussion Paper proposes to remove this national discretion for central governments, but suggests that a distinction between domestic-currency and foreign-currency exposures should be maintained and that different standardized risk weights should be applied to those exposure classes.

We agree with the Committee's observation that sovereign exposures that are denominated in a foreign currency bear a higher credit risk than exposures that are denominated in a domestic currency because the central government is exposed to additional foreign exchange risk. However, we do not believe that the bank's sources of funding should be included in this consideration. In a typical banking operation, funding is procured through an independent treasury function that accesses national and international capital markets as well as other sources of funding. The raised funding is then allocated to investment opportunities based on a broad range of quantitative and qualitative factors irrespective of where the funding was sourced from. We agree therefore with the observation in the Discussion Paper that in practice funding sources are somewhat fungible and not necessarily linked to specific assets. In our view, this highlights that the source of funding does not directly contribute to a bank's credit risk exposure from sovereign entities and should therefore not be a criterion in the risk weighting process. We are also concerned that any requirement to trace individual investments to their sources of funding imposes significant cost and efforts on banks, because the requirement is not aligned with the treasury processes.

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?

Paragraph 9 of BCBS d424 contains a joint risk weight table for sovereigns and central banks. In addition, paragraph 11 of BCBS d424 provides national discretion to allocate a risk weighting to public sector entities (a) either according to the external rating of the sovereign or (b) according to the external rating of the public sector entity. The document contains also a set of examples as to how national supervisors might categorize public sector entities based on their revenue-raising powers. The discussion paper proposes to replace these requirements through separate sets of risk weights for central governments and central banks and to introduce a differentiated risk weighting system for 'other sovereign entities' based on newly developed autonomy and support criteria.

We are concerned about the proposed relative rank ordering of 'other sovereign entities'. In our view, the concerns mentioned in our response to Question 3 are equally applicable to the assessment of the autonomy and support criteria for other sovereign entities. In particular, we believe that the proposed criteria would impose an operational burden on banks and be highly judgmental in many situations. In addition, we are not convinced that the proposal would always lead to a categorisation of other sovereign entities that is aligned with their risk profile. For example, it is not clear to us how the criteria would be applied to the current situation in Catalonia. In our view, the region would technically meet the autonomy and support criteria. In the absence of a region-specific credit rating, the proposed guidance would apply the risk weighting of the central government of Spain to Catalonia and in effect ignore the political uncertainty associated with the Catalan independence movement. We refer therefore to the suggestion in our response to Question 3 that any assessment of other sovereign entities including the application of the autonomy and support criteria should be provided centrally by the BIS and the national supervisors.

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?

We acknowledge the challenges associated with building internal models for sovereign exposures due to the low default nature of these portfolios. However, based on our analysis we believe internal models can be built for sovereign exposures that do effectively and consistently differentiate risk. As such, we believe the Advanced Internal Ratings Based Approach (A-IRB) should remain available to banks where there is strong evidence that their models perform well.

Under the IRB approach, risk-weights are sensitive to the Probabilities of Default (PDs) of the sovereign counterparties (and Loss Given Default, LGD in the case of A-IRB). Removing all IRB approaches for sovereign exposure would effectively remove the risk sensitivity from the credit risk management frameworks that banks have invested heavily in to develop and maintain. In our view, it is important to keep a certain level of discrimination and risk sensitivity in the framework.

If the Committee should conclude that the level of modelling for sovereign exposures must be reduced then we would for this reason strongly encourage the Committee to consider retaining the Foundations IRB Approach (F-IRB). We would note this is a similar approach to the one the BCBS is adopting for banks and other financial institutions as well as for large and mid-sized corporates.

If the Committee should decide that the use of all internal models (i.e. A-IRB and F-IRB) must not be allowed then the standardised approach would need to be significantly revised to introduce more risk sensitivity. In addition there would need to be an impact assessment so that the impact is fully understood as such a material change would potentially lead to a significant change in a bank's key regulatory ratios.

We would also support transitional arrangements if the Committee should decide to move from a fully modelled approach (i.e. PD, LGD and Exposure at Default, EAD) to one where modelling is completely prohibited. A potential solution would be an appropriate transition period during which the use of internal models would continue to be permitted whilst a standardised approach is phased in.

We would ask that if the use of all internal models is to be prohibited then the Committee provides clear guidance to national supervisors on how to manage the submission process for models that banks will develop before any changes are implemented.

In addition, we would also welcome clarity from the Committee around how removing modelling approaches would impact a bank's IRB coverage ratio. We believe a bank's coverage ratio should not simply be reduced because the Committee is removing modelling approaches for particular asset classes.

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?

Paragraphs 7-12 of BCBS d424 summarize the current requirements for application of the standardized approach to sovereign exposures. The guidance contains separate risk weight tables for sovereigns and central banks as well as for non-central government public sector entities. Paragraph 8 of BCBS d424 grants also national discretion to apply a lower risk weight to banks' exposures to their sovereign of incorporation denominated in domestic currency and funded in that currency. The Discussion Paper introduces a more differentiated and recalibrated set of those risk weight tables. Under the proposal, any national discretion to lower the risk weights for domestic sovereign exposures would be removed. However, the revised risk weight tables would include preferential risk weights for central bank exposures.

We generally agree with the suggested structure of the risk weight tables, which is aligned with the various types of sovereign entities that the Committee defines in the Discussion Paper. But we believe that the Committee should consider the following issues:

- Conceptually, the redesigned standardized approach and the associated use of rating and non-rating based indicators represents a model approach of its own. That model differs from the IRB approach mainly in the degree of risk sensitivity and complexity. If the BCBS should ultimately decide to remove the IRB approaches for sovereign exposures, it would implicitly support a view that banks should apply a less risk sensitive, simplified model, such as the proposed standardized approach.
- We welcome the Committee's view that a preferential treatment of central banks should be maintained. However, we do not believe that the Committee has provided a compelling reason as to why the national discretion to lower the risk weights for other domestic sovereign exposures should be removed and recommend that the BCBS retains the current choice ideally for all countries or, at least, for all major OECD economies.
- The Committee emphasizes that the calibration of the risk weight tables in the Discussion Paper is provided for illustrative purposes only and that the final risk weightings might differ from the example. We believe that any recalibration of the final risk weights should ensure that the proposals in the Discussion Paper do not implicitly increase the overall risk weighting of sovereign exposures. In particular, we believe that the potential removal of the IRB approaches and the national discretion to lower the risk weights for domestic sovereign would each result in the need for lower risk weights under the standardized approach
- The BCBS explains in the Discussion Paper that exposures to central banks that are denominated in the domestic currency of the central bank could be subject to a 0% risk weight. In addition, exposures to central banks in jurisdictions where monetary policy tools are centred on the exchange rate would also receive a 0% risk weight. The Committee believes that applying positive risk weights to such exposures could hinder the operationalisation and transmission of monetary policy. Even though we acknowledge the Committee's concerns and generally support 0% risk weights for all central government exposures, we do not believe that monetary policy considerations should play a role in the design of risk weighted capital requirements. A bank is exposed to sovereign risk, regardless of the monetary policy that a particular country pursues. For example, we do not believe that the assessment methodology applied to Denmark or Qatar should be different from that applied to Norway or Turkey only because the former

countries have a fixed exchange rate system and the latter countries have a floating exchange rate system. Rather, the same risk weights should apply to all countries that share similar risk characteristics.

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

We believe the type of factors that the Committee is considering are already taken into account by the credit rating agencies when determining external ratings of sovereign entities. In our view, the requirement for banks to consider additional non-rating based would lead to a duplication of efforts without yielding any significant benefits.

Furthermore, in BCBS d424, paragraph 4 sets out due-diligence requirements for all exposure types that require the use of external ratings with the exception of sovereign exposures (footnote 6). In the Discussion Paper on sovereign exposures, the Committee notes it considered an alternative approach where banks could be required to perform due diligence on their sovereign exposures to ensure they have appropriately considered all available information regarding the risk profile and characteristics of their sovereign counterparties. We view this as contradictory to the language in BCBS d424 and strongly encourage the BCBS to maintain its alignment with the Basel III text in order to avoid inconsistencies and recognizing the fact that sovereign ratings are already subject to significant scrutiny by the agencies and any shortcomings can be addressed under Pillar 2. We therefore question the need for due diligence outside the scope of Pillar 2 as per Question 11.

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?

Paragraph 13 of the BCBS standard 'Supervisory framework for measuring and controlling large exposures' (BCBS 283) exempts sovereigns and central banks from the large exposure calculation. The Discussion Paper proposes to amend the scope of the large exposure calculation to include certain sovereign exposures. The exposures would be measured in accordance with the revised large exposure requirements set out in BCBS 283, which foresee among others the mandatory application of a collateral substitution approach. Under such an approach exposures that are collateralized through sovereign securities would be allocated to the sovereign entity that has issued the collateral, rather than to the contractual counterparty of the instrument that is being collateralized. We expect that this revision will result in a significant increase of exposures that are attributed to sovereign entities, when compared to today's level of sovereign exposures. The proposals in the Discussion Paper would then apply a marginal risk weight add-on approach to those higher exposure levels.

We ask the BCBS to reconsider this proposal, as we are concerned that it might bear unintended consequences for both, banks and their supervisors. The reason is that securities issued by a central government are commonly used as collateral in lending and derivative transactions. The proposal to limit the exposures which include the recognition of such collateral might cause banks to exceed the large exposure limits with respect to the central government that has issued the collateral securities.

Even though a bank will often establish collateral quality criteria, it will have limited influence over the specific securities that a counterparty posts as collateral. This means that unilateral action by the counterparty could cause a bank to exceed involuntarily its large exposure limits at any time. This problem is particularly acute in commonly used collateral such as securities issued by a central government. Subjecting these to an upper

limit might force banks to adopt an approach to collateral management that is driven by regulatory rather than by economic considerations. In an extreme scenario, a bank would need to reject the acceptance of high quality collateral from the central government of a particular jurisdiction, because it holds already significant collateral positions from that government. If so, there is a risk that high quality collateral would potentially be replaced by lower quality collateral solely with the intent to optimise the bank's regulatory position. We believe that this outcome would neither be compatible with the risk management objectives of the bank nor with the prudential oversight goals of the local supervisors.

From a macro-economic perspective, we note that the proposal might make the use of collateral in the form of central government securities less attractive. This could potentially reduce the liquidity of the financial markets in those securities and as a consequence impact the ability of a central government to refinance itself.

We would also ask the Committee to reconsider its use of a marginal weighting of exposures which increases with the size of the exposure and which results in incremental exposures having a much greater contribution towards reaching the upper limit when we are already close to this limit. This is undesirable as it is precisely when we already have a sizeable exposure that we have the need to monitor such an exposure most carefully and when the increase in weighting applied to changes makes it most difficult to do so. As a result we would be required to set internal limits well below the regulatory upper limit in order to create a buffer for the weighting impact.

In particular, we see that with the current calibration an unweighted exposure of 250% of Tier 1 capital would result in a weighted exposure of 10% of Tier 1 causing it to be classified as a large exposure, that an increase in the unweighted exposure of 50% of Tier 1 capital would raise the weighted exposure to 17.5% of Tier 1 and, at a marginal weight of 30%, a further increase of only 25% of Tier 1 capital in the unweighted exposure would cause us to be at the upper limit for weighted exposures of 25% of Tier 1 capital. From a monitoring perspective it would be preferable to have a fixed weight to be applied to the exposures, irrespective of the current size, so that the impact of an incremental exposure is always known. We note that to achieve the same upper limit on unweighted exposure as in the proposal, this fixed weight would be 7.7%.

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?

According to paragraph 173 of BCBS d424, national supervisors have the discretion of allowing banks to apply a collateral haircut of 0% to qualifying repo transactions with core market participants which use as collateral sovereign securities or the securities of Public Sector Entities (PSEs) that qualify for a risk weight of 0% under the standardized approach. In the Discussion Paper the Committee is proposing to remove this national discretion and to apply positive haircuts to such transactions within the general principles of the credit risk mitigation framework.

We are concerned that the removal of preferential haircuts for sovereign collateral in those transactions would not provide an incentive for banks to use such collateral. This would result in banks replacing sovereign collateral with other lower quality collateral types. The proposal could therefore have a negative impact on the risk position of banks and simultaneously reduce liquidity in government bonds markets.

We acknowledge that haircuts under the risk-based capital framework and valuation adjustments under the liquidity standards follow different concepts, because capital related haircuts intend to protect the bank

against volatility in the value of collateral securities, while mandatory valuation adjustments for level 2a and 2b assets in the liquidity standards address the risk that collateral could only be sold at a discount in a distressed market environment. However, we believe that there are similarities between the two valuation approaches. The High Quality Liquid Assets (HQLA) requirements in paragraph 24 of BCBS document 238 'Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools' include low risk, low volatility and low correlation with other risky assets. We agree that these are characteristics of an instrument with a stable valuation that in essence eliminate the need for valuation adjustments. At the same time, we believe that these are equally common characteristics of sovereign repo-style transactions. Paragraph 150 of BCBS d424 imposes even stricter conditions on sovereign collateral, when it sets out further conditions for the design of the legal contracts and settlement techniques for those instruments. Thus, we think that, similar to the treatment of HQLA assets under the liquidity standards, qualifying sovereign securities that are used as repo collateral should not require valuation haircuts in the risk based capital framework.

Moreover, both sovereign collateral used in repo-style transactions and unencumbered government securities that are treated as HQLA under the liquidity standards must currently meet the same condition, according to which a 0% risk weight must be attributed to those instruments under the standardized approach. We are concerned that removing the latter requirement as suggested in the discussion paper will affect both repo-style collateral and HQLA adversely.

Therefore, before making any such changes that could have a negative effect on banks' collateral and liquidity positions, we recommend that under chapters 1-3 of the Discussion Paper, the BCBS shares any historical analysis it has conducted to substantiate the claim that sovereign repo-style transactions are negatively affected during crises to the extent that would warrant a change in haircuts.

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

In paragraphs 726-756 of the Pillar 2 section of BCBS Document 'International Convergence of Capital Measurement and Capital Standards' (BCBS 128) a principle is established by which banks should have in place a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. The guidance covers a range of risk types and sets out how banks should assess those risks. In addition, there are also general rules around monitoring and reporting.

In the Discussion Paper, the Committee is proposing to complement the principles in BCBS 128 with explicit requirements for sovereign exposures (e.g. banks should have in place effective internal policies and have systems and controls to identify, measure, monitor and control risk). In addition, banks could be required to maintain a set of sovereign fiscal and non-fiscal indicators to evaluate on a regular basis, the sensitivity and reasonableness of key assumptions in their choice of material indicators used for their internal capital assessment.

We agree that banks should have internal policies, systems and controls to identify, measure, monitor and control risk arising from sovereign exposures. However, we believe this is already the case and that the general principles set out in BCBS 128 do apply to sovereign exposures. In our view, the proposal to add additional language explicit to sovereign exposures would be duplicative in nature and raise the question of why similar guidance has not been provided with respect to other asset classes.

In addition, we struggle to distinguish between the use of non-rating based indicators as part of the Pillar 1 due diligence process to assess sovereign exposures and the proposed Pillar 2 requirement to use fiscal and non-fiscal indicators as part of the monitoring process of sovereign exposures. We believe that further clarity

is needed on differentiating monitoring requirements from supervisory expectations around due diligence. Furthermore, the concerns expressed in our response to Question 8 are equally applicable to the proposed use of fiscal and non-fiscal indicators as part of a monitoring process. This includes the high degree of costs and efforts to conduct such an assessment, the judgmental nature of the analysis and a potential duplication of the work that has already been performed by the credit rating agencies and similar bodies.

We note that the proposals in our response to Question 7 would remove the need for Pillar 2 guidance as regulatory prescribed risk-weights would already reflect supervisory judgement. This would help to reduce the complexity and lack of transparency around the setting of Pillar 2 add-on buffers that supervisors deem necessary to remedy perceived deficiencies in the Pillar 1 treatment of sovereign exposures.

Finally, paragraph 7 of the BCBS document 'Principles for sound stress testing practices and supervision' (BCBS 155) states that stress tests should cover a range of risk and business areas, including at the firm wide level. The Discussion Paper proposes to complement this general principle through the provision of specific scenarios relating to a deterioration of a sovereign's creditworthiness and its implications on sovereign debt markets. While we agree that sovereign default scenarios should be considered in a bank's stress tests, we believe that national supervisors and banks should determine the relevant scenarios, rather than the BCBS. Thus, we propose that stress testing be removed from the scope of the Committee's project on sovereign exposures.

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

Paragraph 809 of BCBS 128 explains that the purpose of Pillar 3 – market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). We believe that the BCBS has adhered to this principle, when it designed Disclosure Templates 1 and 2 in the appendix of the Discussion Paper which require disclosure of central government exposures by jurisdiction and currency denomination. Both factors play a key role in the allocation of counterparty credit risk weights under the proposed amendments to the minimum capital requirements.

However, we consider it to be more difficult to reconcile Disclosure Template 3 in the appendix of the Discussion Paper to the guiding principle. The template focuses on the accounting classification of sovereign exposures. This aspect is not discussed in earlier chapters of the discussion paper and we do also not see the informational value of the accounting classification in the context of credit risk exposure. Furthermore, we are concerned that adoption of Disclosure Template 3 would impose significant implementation cost on banks, as the proposed reconciliation between regulatory exposure amounts and accounting assets and liabilities is not readily available in banks' data systems. Therefore, we ask the Committee to either remove Disclosure Template 3 or to clarify the informational objective that it pursues with the template.

Should the BCBS continue to require the disclosure of Disclosure Template 3, we believe that further implementation guidance will be required as to how the template should be filled-in. In particular, we have the following questions:

- Does the term exposure in Disclosure Template 3 relate to regulatory amounts or to accounting values?
- Is the distinction between gross and net exposure amounts limited to provisions or should other adjustments, such as netting, be also considered?
- Does the concept of indirect sovereign exposures in derivatives relate to the derivative underlying, collateral or both?

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?

The Discussion Paper proposes that home authorities should be encouraged to recognize the prudential treatment of sovereign exposures applied by host authorities. Being an internationally active bank we strongly agree with the proposal. Introduction of such a principle would help to establish a level playing field between banks that have their legal seat in a particular jurisdiction and those banks that operate through branches or subsidiaries in that jurisdiction. Furthermore, we see no reason why the proposed principle should be limited to sovereign exposures.

Paragraphs 136-150 of BCBS document 189 'Basel III: A global regulatory framework for more resilient banks and banking systems' introduces a countercyclical capital buffer. The requirements include the concept of jurisdictional reciprocity, according to which a home authority must apply against a bank's exposure in a particular country, as a minimum, the countercyclical buffer rate set by the host authority and vice versa. The BIS supports the concept of reciprocity through disclosure of a central register of the countercyclical capital buffer rates of all BIS membership states. This could be a blueprint for a treatment of sovereign exposures, according to which home and host authorities would be required to use the same risk weights for a particular sovereign entity. We believe that such a proposal would improve the comparability of the regulatory treatment of sovereign exposures among internationally active banks.

However, we recommend that the Committee also considers more far reaching concepts of reciprocity. In particular, the Committee could require that a home authority deducts the capital charges that a host authority imposes on a bank when setting the capital requirements for the home jurisdiction. Such a requirement would establish a fully levelled playing field across internationally active banks.

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

We agree with the Committee's observation that the leverage ratio framework and the liquidity standards have only been recently finalised. In our view, any further changes to those regulatory requirements should be postponed until the Committee has been able to observe and analyse the practical implications of the new requirements at a global level. We urge the BCBS to continuously monitor potential implications for the leverage ratio and liquidity standards throughout its sovereign entity project and to take the necessary steps to avoid any unintentional changes to those regulatory frameworks. In particular, we ask the BCBS to ensure that the removal of a 0% risk weighting for central governments does indeed have no unintended repercussions on the treatment of HQLA assets under the liquidity standards, as suggested in the Discussion Paper.