

Set up in 1990, the Czech Banking Association (CBA) is the voice of the Czech banking sector. The CBA represents the interests of 38 banks and foreign branches operating in the Czech Republic: large and small, wholesale and retail institutions. The CBA is committed to supporting quality regulation and supervision and consequently the stability of the banking sector. It advocates free and fair competition and supports the banks' efforts to increase their efficiency and competitiveness.

We appreciate the opportunity to comment on the BCBS **DISCUSSION PAPER “THE REGULATORY TREATMENT OF SOVEREIGN EXPOSURES”** and would like to share our views on the subject.

General comments

- *Sovereign risk needs to be assessed from the perspective of the whole financial sector and not only for banks.*
- *We believe that it is necessary to distinguish between central bank exposures and sovereign exposures.*
- *It should be differentiated between various types of sovereign entities. (No single flat positive risk weight should be set)*
- *It would be worth to consider additional analysis and impacts on other regulation e.g.:*
 - *LCR standard describes Level1 assets as those with 0% RW. It would have to be adjusted.*
 - *To align the proposal with current valid accounting standards IFRS9 - wording (e.g. page 32 uses old accounting categories for securities (AFS, HTM))*
 - *What would happen if the domestic players would stop market making?*
 - *What would happen if local sovereigns would lose the role of a benchmark?*
 - *What would happen if there is a large and fast disposal of sovereign bonds?*
- *It is extremely important that proper impact assessment of the new proposed regulation on current capital requirements is made.*
- *It is crucial to allow sufficiently long phase-in period (e.g. 3 years) after potential adoption of the regulation.*
- *Important factors (such as: currency, liquidity ratios, rating, country and financial sector specifics, L/D ratio, regulatory environment...) should be stressed when setting the thresholds.*
- *A correlation analysis should be included. Would higher diversification among countries within monetary unions improve the risk profile and how much in comparison to countries outside monetary unions?*
- *Some proposals for monetary unions that would start harmonisation of fiscal policies should be included.*

- *Crowding in/out effect depends on several factors including the structural characteristics of the economies (reflecting e.g. L/D ratios). This topic should be further analysed.*
- *Guidelines for IRB approach would be welcomed.*
- *TB/BB: We propose to include a different treatment for TB positions (current approach).*

Answers to specific questions from the discussion paper

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

We see the current list and description of channels of sovereign risk enough exhaustive and sufficiently described.

Just a note to the statistical analysis of Frequency of sovereign default (that is extremely rare) which showed that the frequency of external sovereign debt crises is higher than the frequency of domestic sovereign debt crises - so this is in favour of holding domestic sovereign debt and should be reflected in conclusion about concentration mitigation proposal - like marginal risk weight add-ons.

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?

- *Political risk, reputational risk or policy-related risk. A lack of transparency in government strategy to refinance or central bank eligibility criteria can induce volatility, increase riskiness and credit tightening.*
- *Internal (for profitability calculations) and external (client price) pricing of product in banking industry could be based on bond yield curve as a proxy of risk free rate.*
- *In times of illiquid or poor liquid money market the pricing on the market could be derived from T-bills and Bond YC.*

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

Definition seem to be fine as proposed.

We appreciate differentiation between Central bank exposures and government exposures as well as distinguishing between domestic and foreign currency exposures.

Question:

In case of sub nationals and PSEs is it sufficient that corresponding legislative, constitutional or other arrangements are in place? Or is the specific legal commitment to transfer financial resources necessary?

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?

No, link should not be made with the currency denomination of the funding of the particular bank, but rather with the currency of the particular country's jurisdiction (and the ability to raise taxes).

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?

Yes. But Central Bank exposures' risk weight should be zero (or very close to zero) as bankruptcies of central banks are extremely rare.

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?

Both IRB/Standard approaches have cons and pros.

We support the standardized approach treatment.

Removal of IRB approach could decrease the costs for additional models' creation and validation. The advantage of standardized approach is more simplicity, clarity and better comparability across banks.

The question whether standardized approach is sufficient is – what should be the degree of granularity.

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?

Limits should take into account split based on sovereign entity, currency, LCR regulatory limit and ratings.

The Central banks can issue local currency to refinance their obligations autonomously therefore the zero-risk weight is reasonable (the Central bank cannot default in the local currency).

Sovereign bonds are necessary for liquidity management therefore some preferential treatment is necessary. (Close to) Zero risk weight treatment is needed at least for the part of the portfolio sovereign bonds that cover LCR regulatory requirement.

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

We see the rating as sufficient indicator for determining sovereign exposure. To retain simplicity and clarity, no other specific and supporting non-rating indicators are needed.

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?

1) The first best solution we support is – not to introduce any marginal risk weight add-on.

2) As a second-best option we support the approach to have marginal risk weight add-ons only for foreign currencies and not to apply any add-ons on sovereign exposures in domestic currency:

- *Countries which have their own currency as a tool for independent monetary policy would be very punished by introduction of marginal add-on to domestic currency sovereign exposures because it would lead to replacing domestic currency sovereign exposures by the foreign currency exposures (that are riskier) and lead to increase FX risk and exposure to foreign currencies although the funding of such sector is mostly coming from local domestic currency retail demand deposits.*
- *Market specificities must also be taken into account – e.g. replacement possibilities of investments (e.g. not sufficiently developed domestic capital market to replace domestic sovereign exposures in local Banking Books) or over-liquid situation of the whole domestic banking sector and other.*

- *On the other hand, increasing exposure of foreign investments will lead to higher demand for hedging of FX risk and funding in foreign currencies which lead to increase of CIRS operations and higher costs and adverse impact on the riskiness of the banks.*

3) *As the last option we see the possibility to introduce marginal risk weight add-on but in a wider range:*

- *We recommend to distinguish between local and foreign currency exposures.*
- *For local currencies concentration add-on (in wider ranges) should be applied only in case there is no domestic regulatory framework on concentration risk of sovereign exposures.*
- *E.g. in the Czech Republic the Czech National Bank approach for review and evaluation of sovereign concentration risk (so called Sovereign Risk Indicator) is already in place. This is a conditionally based approach where concentration risk capital charge is applied if Sovereign Risk Indicator outlook is worse. In case that the Sovereign Risk Indicator outlook is fine then no add-on for concentration risk is applied.*

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 support No removal of current repo-style discretion to apply 0 haircut.

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

No

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

No additional disclosures are needed.

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?

Yes.

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

Yes, make it compatible with liquidity-related regulation CRR (HQLA for LCR and NSFR).

We believe that our response is sufficiently clear and our views are helpful.