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FRENCH BANKING FEDERATION RESPONSE TO DISCUSSION PAPER ON THE REGULATORY TREATMENT OF SOVEREIGN EXPOSURES

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to share its comments on the BCBS discussion paper on the regulatory treatment of sovereign exposures.

1- General Comments

The paper tackles especially proposals of new prudential treatment of sovereign exposures through the three pillars of Basel framework. To a large extent, the consultation has no real purpose, as it has been clearly stated by the GHOs in December 2017 that there would be no change in the treatment of sovereign exposure. We consider that the December package is final and definitive, and reopening the subject of sovereign exposure would create an additional uncertainty, in contradiction with GHOS decision. Therefore, the proposals contained in the Discussion document are too wide-ranging. We are not in favour of any changes in the current framework.

2- Detailed Comments

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 acknowledge the in-depth work done by the Basel Committee in order to analyse the sovereign risk, its channels and empirical evidence as well as the holistic role of sovereign. We are broadly in line with the conclusions of the Basel Committee in chapters 1, 2 and 3.

The past ten years have seen significant changes in banks business models (de-risking of balance sheets) and in the prudential framework (set up of the leverage, liquidity and funding ratios). These factors have resulted in banks' balance sheet containing a higher proportion of domestic government debt.

Regarding European Banks, this is set out in the EBA report on liquidity measures¹. Under this report it should be noted that EU banks showed an important shortfall on the LCR ratio in 2011 and this shortfall has been progressively reduced in the period 2011- 2016.

The LCR is the ratio between HQLA (high Quality Liquid Assets) and the liquidity needs to the horizon of 30 days. Figure 5 of the EBA report (page 14) shows that if the liquidity needs have not been reduced, the amount of HQLA has significantly increased and the EBA recognises (page 13) that the "increase in the LCR can be attributed mainly to an increase in liquid assets".

The EBA also indicates that between 2011 and 2016, banks exposures to HQLA have increased from (roughly) 1 250 €bn to 2 520 €bn and more precisely central bank deposit have increased by (roughly) 600 €bn and other HQLA (including sovereign bonds) by (roughly) 600 €bn.

Given this regulatory pressure, and the narrow definition of HQLA Level 1 assets, it should therefore not come as a surprise that bank's holdings of sovereign exposure has increased, rather than decreased, as banks have been clearly incentivized to hold sovereign debt as liquidity buffers. Therefore it would be a complete contradiction to implement a regulation giving an opposite incentive. Any potential future review of sovereign treatment should at the same time revisit the LCR calibration and the definition of HQLA assets and haircuts, with the view to provide alternatives to banks other than accumulating sovereign exposure.

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?

The Committee should also take into consideration the role of sovereign exposures in providing credit to the economy in the form of direct lending to Sovereigns and PSEs and also exposures to private actors guaranteed by sovereigns or PSEs in multiple sectors, such as infrastructure and trade finance. It is a long tradition for sovereigns to step into areas where the private sector alone cannot properly fund the economy and this is often achieved by using bank funding supported by direct or indirect recourse to a sovereign entity. These exposures represent very large amounts for many banks. One example is ECA credit, whereby an export contract benefits from deferred payments guaranteed or insured by the state-sponsored export credit agency of the exporting country. The type of risk generated by these exposures should also be carefully analysed to take into account the fact that default risk on the underlying borrowing is generated by a third-party borrower, and that the exposure to sovereign risk is only contingent to borrower default.

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

For the sake of comparability, we agree that no step to implement any new treatment on sovereign exposure should be taken, without a prerequisite to revise and standardise the definition and categorisation of sovereign exposures.

¹"EBA report on liquidity measures under article 509(1) of the CRR", december 2017

We think that the primary challenge for the Committee will be to establish a clear definition of “other sovereigns”

However, an appropriate level of flexibility is needed. The definition of sovereign exposure should include certain regional governments or local authorities under national discretion, following the same pattern that what is accepted for certain PSE subject to national discretion. Some local jurisdictions already follow this approach.

This level of flexibility, although necessary, should not lead to discrepancies between jurisdictions or countries. For instance, the definition and the measure of sovereign exposures should be homogeneous across countries.

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?

It could make sense to distinguish between local currency and foreign currency debt. Rating agencies have publicly available methodologies to that effect, as banks in their internal Models.

Nevertheless, we consider that any distinction on the risk-weight of Local Currency versus Foreign Currency exposures is likely to disadvantage export financing guaranteed by an ECA. Given the dominant role of USD for export financing, any guarantee other than from the US ECA would be penalized.

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?

In overall, we agree with the features which are listed in the definition of sovereign exposures. The risk analysis of sovereign exposures is more likely to be based on a case-by-case basis leading to also individual differentiation elements in the analysis. Such differentiation can only be done in the context of internal models.

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 minimum level of sovereign risk holdings in a bank is determined by the need to comply with the LCR. Therefore, it would be contradictory and detrimental to the functioning of the financial system to request a cost of capital to those mandatory investments.

Therefore we are against any change in the Pillar 1 framework. Specifically, we do not support the abolition of IRB-A approaches which still have a role to play in assessing the expected loss and estimating the capital requirement.

- The possibility and ability to model the PD / rating with an internal approach will avoid relying too much on external ratings, especially rating agencies, thus mitigating undesirable procyclicality and self-fulfilling prophecies; It should be noted that, to the best of our knowledge, the discussion paper has been produced by the Basel Committee without any analysis of existing bank models,

the methodologies developed, and their governance. Therefore, there is absolutely no basis to disallow such models, especially to replace them with less risk-sensitive alternatives.

- Under the standardized approach, certain types of exposures (such as territorial agencies) would be considered as unrated and would be subject to a conservative weighting, while it is still possible to analyse more accurately their risk profile through IRB parameters.

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?

We formally warn the Basel committee against the major unintended consequences that would result from enforcing a standardized approach for sovereign exposure. As mentioned above, banks have significantly increase their holdings in HQLA to comply with LCR. Therefore, it would be contradictory and detrimental to the functioning of the banking business to request a cost of capital to those mandatory investments.

Worse, the reliance on external rating agencies (which is prevented in some jurisdiction such as the US) would make the financial system extremely vulnerable to rating migration, that would apply at the same time to all banks owning a given sovereign debt.

As regard the proposals set out in the discussion paper, we would like to highlight the following issues.

External ratings

In order to bring more risk sensitivity to the grid introduced in table 6, we would be in favour of splitting the “Below BBB- and unrated” into separate categories:

- BBB- to B-
- B- to default
- unrated

The Basel Committee should also consider that many sovereign counterparties (as per the proposed definition including PSEs) do not have external ratings.

OECD Score

The use of OECD country risk classification (CRC) is proposed by the Committee as an alternative to external credit ratings. According to the OECD score methodology², *“The country risk classifications (CRC) are not sovereign risk classifications and should not, therefore, be compared with the sovereign risk classifications of private credit rating agencies (CRAs). Conceptually, they are more similar to the ‘country ceilings’”*.

Sovereign rating capture the risk of a country defaulting on its commercial debt whereas country risk and country ceilings cover the downside of a country’s business environment (inc. level of corruption, legal environment, etc). The level of country and sovereign risks may diverge for some countries.

² OECD website : <http://www.oecd.org/tad/xcred/crc.htm>

Therefore, the use of OECD score in jurisdictions that do not recognize the use of external ratings will reduce comparability across jurisdictions.

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

Of course the credit risk analysis of sovereign counterparts, like other counterparts, relies on multiple criteria that represent the credit culture of banks, as refined through time and default experiences. Not surprisingly, most of the proposed indicators are already taken into account through rating methodologies of credit rating agencies and banks' internal models. Therefore we see no benefit of replacing the existing internal models with a similar, less developed standardized approach.

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?

We think that the concentration risk is already sufficiently tackled by several prudential measures. In particular:

- Sovereign exposures are included in the leverage ratio which serves as the backstop measure in the scope of micro-prudential requirements.
- The sovereign risk concentration is already monitored in recovery plans;

Moreover, the current proposition is to add RWAs regarding concentration risk, bringing conservatism. The rationale of this method is diverted from the initial objective of mitigating concentration risk. By the way, the large exposures framework and the RWA framework serve different purposes:

- The core aim of a large exposures regime is "to prevent a firm from incurring disproportionately large losses as a result of the failure of an individual client or group of connected clients".
- The aim of the capital ratio is to make sure that banks have enough cushion to absorb a reasonable amount of losses before they become insolvent

Therefore, we do not support marginal risk weight add-ons for concentration risk.

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 are not in favour of the removal of the allowed zero percent haircut for sovereign repo-style transactions.

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

The absence of international consensus on a Pillar 1 measure should not translate into national discretion given to supervisors to include a quasi Pillar 1 capital charge in Pillar 2. This would create an unlevel playing field across 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?

We think that the disclosures requirements as set out in the annex of the discussion paper are too granular.

Banks are already disclosing sufficient information on their sovereign debt holdings.

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?

As a general rule, we are in favour of convergence, especially as host authorities are able to know better their jurisdiction and related characteristics of sovereign exposures. But we warn the Basel Committee that reaching such mutual recognition may be extremely challenging in the current trend toward fragmentation. Therefore, we do not think such approach could mitigate the unintended consequences of changing the sovereign treatment.

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

No, as per the GHOS decision in December 2017.