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SUBJECT **Discussion paper on the regulatory treatment of sovereign exposure, published on 07.12.2017 (BCBS d425)**

The German Federal Ministry of Finance is pleased to provide comments on the BCBS Discussion Paper on the regulatory treatment of sovereign exposures. We very much welcome the initiative by the Committee to share its ideas on this highly important topic and we are grateful for the opportunity to provide our detailed comments.

The German Ministry of Finance fully supports the initiative to change the current regulatory treatment of sovereign exposures. The national discretion to exempt domestic sovereign exposures from both credit and concentration risk regulation is a key source of the sovereign-bank nexus. A regulatory framework that is not sufficiently risk-sensitive leads to an underestimation of sovereign risk, limiting market incentives for sound fiscal policies. As the current framework for sovereign exposures lacks risk-sensitivity compared with the regulatory treatment of other asset classes, it reduces the incentives for investments into the private sector, thus providing the basis for a crowding out of private debt.

A reform is thus imperative and given the nature of these risks they should be addressed as Pillar I requirements. A sovereign default would have severe consequences not only for the domestic banking sector but also for the whole economy itself. Yet, if the banking sector is ex ante better equipped for such scenarios through a reliable regulatory framework, then spill-over effects of sovereigns' stress to the banking sector are significantly reduced ex post.

In our view, the pivotal aspect of a reform is the removal of national discretion to exempt domestic sovereign exposures from credit and concentration risk regulation. Therefore, our

Page 2 major concern is that either continued national discretion or an adoption of only some parts of a new regulatory treatment will be pursued as a way forward. We hence call on the BCBS to continue working on the development of an international standard for the regulatory treatment of sovereign exposures that addresses credit and concentration risks in a sound manner.

Our key comments can be summarised as follows:

- The status quo, allowing states to exempt domestic exposures from regulation, lacks risk-sensitivity and ignores risks associated with sovereign exposures. From a regulatory perspective, this underestimation of risks of sovereign exposures is imprudent and distorts financial markets. The only way forward is thus to remove national discretion.
- A suitable standardized approach has to adequately reflect actual credit risk of sovereign exposure. The proposed calibration is too soft to address inherent credit risk in a suitable manner.
- Introducing risk-based charges for concentration risk should be used for diversifying banks' sovereign portfolios.
- Internal models are currently the only functioning tool to consider sovereigns' credit risk. Although we acknowledge the problems associated with internal models, their use should only be limited, if replaced by a suitable standardized approach.

We encourage the Committee to continue its work on the regulatory treatment of sovereign exposures and to remember its obligation to work for a safe and stable banking sector in which risks are properly addressed and adequately backed with capital.

Specific Comments

Definition and classification of sovereigns [Q3 and Q5]

Acknowledging the varying institutional configurations in different countries, the proposal for defining and classifying sovereign exposures seems reasonable. The approach of allowing national discretion under well-defined rules strikes a sensible balance between international coherence and respecting national specificities. In order to ensure a consistent application, there needs to be more specific guidance on the conditions under which the 'autonomy criterion' and the 'support criterion' can be fulfilled. Certain highly important conditions are not specified in sufficient detail: For instance, the conditions under which revenues of an 'autonomous' sovereign entity can be deemed as sufficient to meet its financial obligations should be defined more precisely in order to ensure a comparable treatment across countries. The same holds for arrangements to facilitate the transfer of financial resources by another sovereign entity. The conditions under which such arrangements are deemed sufficient for fulfilling the 'support criterion' require more guidance. Moreover, the consistent interpretation of these criteria across nations should be closely monitored if a regulatory reform were to be implemented.

As long as there is national discretion to apply a zero percent risk-weight for domestic sovereign exposures, the removal of the IRBA is likely to lead to less capital being held for sovereign risk, especially for lower rated, more risky counterparties. Hence, if IRBA exposures were to migrate to the SA without making the latter more stringent, an overall reduction of capital held against sovereign exposures were to be expected. Given the goal of more risk-adequate pricing and ensuring financial stability any reform that might decrease the amount of capital held for sovereign risks should be ruled out.

Introducing charges for credit risk [Q7 and Q8]

We very much welcome the proposal to remove national discretion for the application of zero risk-weights to domestic sovereign exposures. However, the proposed calibration of risk-weights is too low to fully capture actual risk and hence to end the market distortions that the current regulatory treatment of sovereign exposures induces, especially for lower rated, more risky countries. The calibration should at least take into account the current risk exposure amount according to IRBA. Moreover, the proposal marks a step backwards with respect to risk-sensitivity of the SA for credit risk given the low number of proposed buckets.

Introducing charges for concentration risk [Q9]

The introduction of concentration risk charges is an element to incentivise a risk-adequate diversification of sovereign exposure and thus improve financial stability. This is of particular importance in the context of currency unions. Given that sovereign exposures are high-quality liquid assets and thus serve an important role for the fulfilment of liquidity requirements, the introduction of marginal risk-weighted add-ons seems sensible.