

Comments on the discussion paper: *The regulatory treatment of sovereign exposures*
issued by the Basel Committee of Banking Supervision

Japanese Bankers Association

We, the Japanese Bankers Association (“JBA”), would like to express our gratitude for the opportunity to comment on the discussion paper: *The regulatory treatment of sovereign exposures*, issued on December 7, 2017 by the Basel Committee on Banking Supervision (“BCBS”).

[Executive Summary]

We support the decision by the BCBS to complete its review of the regulatory treatment of sovereign exposures without changes to current rules.

As recognized by the BCBS, sovereign exposures play an important role as a safe asset in the operation of monetary and fiscal policies as well as in the broader economy including banking system and financial markets. As such, revising the existing regulatory treatment entails a risk of having a significant unintended impact on stability of the financial system and ultimately on the real economy.

In the first place, sovereign exposures are in principle subject to capital charges under the current framework. Based on this, at national discretion, a preferential risk weight (“RW”) appropriate to actual circumstances of each jurisdiction may be applied to sovereign exposures denominated and funded in domestic currency. Sovereign risk varies depending on each jurisdiction’s economic, monetary and fiscal situations, such as the degree of economic maturity, whether a jurisdiction has the power to issue its own currency, and the level of power to impose taxes. Thus, by its nature, sovereign risk is not suited to uniform international standards and the existing treatment which allows certain national discretion is considered to be more appropriate.

Given that the reforms of the global regulatory frameworks triggered by the occurrence of financial crisis have completed through the finalisation of Basel III and regulatory uncertainties have been finally removed, future significant challenges would be to stabilize the new regulatory frameworks and ensure their full, timely and consistent implementation. The discussion paper states that the BCBS might engage in longer-term thinking on regulatory treatment of sovereign exposures. We however believe that engaging in any considerations by itself would give rise to uncertainties in

the new framework. Therefore, the BCBS should not resume considerations on this issue going forward.

[Our response to the questions]

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?

(Our response)

Sovereign exposures play a significantly important role as a safe asset in an exit strategy of central banks' non-traditional monetary easing policy.

Since the financial crisis triggered by the collapse of Lehman Brothers, central banks around the globe have been taking non-traditional monetary easing policy, including quantitative easing. In order to avoid confusion in financial markets in a situation where a non-traditional monetary easing policy enters in an exit phase, a strong capability to purchase government bonds will be needed from those other than the central bank. Enhancing regulation on sovereign exposures would limit private economic entities' capability to purchase government bonds, which may give rise to a risk of triggering financial market turmoil.

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

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?

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?

(Our response)

Given that sovereign risk varies across jurisdictions, the BCBS should not establish an internationally uniform detailed definition.

For example, since the central government and the central bank can avoid default using various means, it is unlikely that only either of the two may default. Given that measures taken by the central government and central bank to avoid default significantly depend on the systems and practices established at respective jurisdictions, it would be unreasonable to distinguish central government exposures from central bank

exposures based on the internationally uniform definition.

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?

(Our response)

We believe that capital requirements for sovereign exposures can be modelled robustly, and that such exposures should not be subject to a standardised approach treatment as a result.

The internal ratings-based (“IRB”) approach is a risk sensitive approach which is based on multiple quantitative and qualitative assessment items and contributes to sound risk management and business operation by banks. For example, at the time of Greek crisis, external credit ratings of Greece government bonds were not downgraded until immediately before Greek’s default whereas banks made a decision to downgrade internal ratings of the government bonds relatively earlier. The standardised approach is less risk sensitive relative to the IRB approach and in the first place cannot be deemed as a preferable approach for sovereign exposures as the standardised approach treats risks uniformly even the extent of sovereign risk varies across jurisdictions depending on financial and monetary conditions.

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?

(Our response)

A standardised approach treatment for sovereign exposures should not be changed.

- Central bank exposures and central government exposures

The Discussion paper indicates to set the RW for central bank exposures at 0% and to apply higher RWs to central government exposures. However, the current treatment of assigning a 0% RW to both of them should be maintained.

Except for countries in the Eurozone, the central bank’s creditworthiness is generally backed by the nation’s creditworthiness. Therefore, it would be unreasonable to establish a framework which applies a higher RW to central government exposures

than central bank exposures.

Also, since both of the exposures to central banks and central governments are closely related to monetary and fiscal policies of respective countries, applying different RWs could lead to concentration on central bank exposures through banks' portfolio preferences and consequently, may undermine such national monetary and fiscal policies.

- Exposures to central banks/governments that are denominated in the local currency

The BCBS should maintain the existing national discretion to apply a RW appropriate to each jurisdiction's actual circumstances to central bank/government exposures that are denominated in the local currency.

Generally, an economic entity which is capable of smoothly purchasing government bonds issued and providing funds in order to financially support the government's economic/social policy is domestic banks. If RWs are applied to safe assets, such as deposits in the central bank and government bonds, the banks' capability to purchase government bonds will be impaired and the market liquidity of government bonds will decline. Moreover, the government's flexible and agile implementation of economic and social policies will be hindered, which will be a risk factor for the stability of economy and society. Furthermore, it may hamper operation and prevalence of the central bank's monetary policy.

In addition, as government bond yields are used as a risk-free rate, assigning a RW to government bonds may undermine the foundation of pricing for various financial assets, giving rise to significant confusion in financial markets and for general consumers using such markets.

While monetisation is being prohibited in principle, it is ultimately possible to avoid default of government bonds of the countries with the power to issue currency by such means. Even if the real value of the local government bond declines due to an increase in interest rates or currency depreciation attributable to monetisation, its impact will be offset by devaluation of debt denominated in the local currency which will occur at the same time. Moreover, the risk of a decline in the present value of government bonds as a result of monetisation is captured under the "interest rate risk" framework.

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?

(Our response)

Banks' holdings of government bonds should not be restricted by adopting the marginal risk weight add-on approach or by any other means.

Generally, an economic entity which is capable of smoothly purchasing government bonds issued and providing funds in order to financially support the government's economic and social policies is domestic banks. If banks' holdings of government bonds are limited, their capability to purchase government bonds will be impaired and the market liquidity of government bonds will decline. Moreover, the government's flexible and agile implementation of economic and social policies will be hindered, which will be a risk factor for the stability of economy and society. Furthermore, it may hamper operation and prevalence of the central bank's monetary policy.

In addition, as government bond yields are used as a risk-free rate, restricting banks' holdings of government bonds by, for example, adopting the marginal risk weight add-on approach may undermine the foundation of pricing for various financial assets, giving rise to significant confusion in financial markets and for general consumers using such markets. Even in normal times, limiting banks' holdings of government bonds will undermine banks' market-making function in the government bond market and may aggravate the market liquidity of government bonds. This will weaken government bond's function as an eligible HQLA or as collateral to be fulfilled in the financial market, which is a risk factor for the stability of the financial system.

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?

(Our response)

Under current market practices in Japan, a zero haircut is set for repo-style transactions of major countries' government bonds, including Japanese bonds. Majority of repo transactions are executed via clearing agencies (e.g. JSCC and FICC) and no haircut is applied to such transactions. In addition, a haircut of zero is also applied to repo-style transactions of government bonds which do not use clearing agencies for the following reasons:

- ① Market participants are comprised of core market participants, such as trust banks, city banks and securities companies; and therefore, given the market structure, the transactions subject to a haircut are unlikely to be conducted under the existing regulations; and

- ② A clause pertaining to margin call is generally included in the contract, and thereby market risk is mitigated.

As described in the Financial Stability Board's report,¹ in the first place, price movements in government securities generally tend not to be procyclical, and thus the risk of devaluation in times of stress is limited. Applying a haircut other than 0% to sovereign repo-style transactions despite such a fact would unnecessarily undermine the efficient use of sovereign as collateral and may weaken the repo market's liquidity.

Given the above, the current discretion to apply a haircut of zero for repo-style transactions should not be removed from the credit risk mitigation framework.

¹ "Strengthening Oversight and Regulation of Shadow Banking - Regulatory framework for haircuts on non-centrally cleared securities financing transactions ", 14 October 2014