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Basel Committee

on Banking Supervision

Subject: Consultation on the BCBS discussion paper on the regulatory treatment of sovereign exposures

Polish Bank Association welcomes the opportunity to contribute to the open discussion concerning the BCBS discussion paper on the regulatory treatment of sovereign exposures that has been published in December 2017.

As the most general remark, we would like to emphasise our understanding of the idea to analyse the different possibilities to set up in other way the prudential requirements for banks in regards to their sovereign exposures. Until today the exposures to the sovereign are still treated by some banks as non-risk activity or the activity with very low risk. The experience of last crisis on financial market indicated clearly that it is not always true. These exposures generate also the risk, however in many cases this risk is much lower in comparison to the risk generated by exposures to private clients. This experience gives the good background to the look for creation of better regulation in this area in the future.

We would like also to draw the attention of international standard setters to the wide implications of potential new regulatory treatment of sovereign exposures. These implications may materialise not in banking activity only but also in whole economy. We see this problem at least in two contexts. Firstly, banks may take the decision in the future to limit their exposures to sovereign. This can

generate the problem for sovereign how to finance its financial needs from external sources. It can also generate the negative problem of higher pressure on sovereign to meet the financial expectation of private investors. This changed regulatory approach may lead to the risk of destabilisation of the public finance in some countries and generate the problem for whole economy. In our opinion the bank exposures to sovereign may mitigate this pressure. Secondly, the exposures to the sovereign are treated as non-capital absorbing form of bank exposures in many countries. If this approach changes in broader way (including the proposal of marginal risk weight add-ons), some banks start to look for other investments, analysing more carefully capital needs generated by different kind of exposures. Today, when the capital requirements for banks are growing nearly in regular way, the role of capital management in bank is also much more crucial and the bank authorities may decide to invest the existing financial sources in more risky exposures. This approach may have negative consequences for stability of financial market as the whole and the economic cycles in the economy. These topics should be carefully analysed before any formal proposal of new prudential standards are recommended.

We would like also to underline that the different prudential treatment of exposures to sovereigns is included in present standardised approach of Basel III. There are different risk weights depending on credit assessment of debt. At national discretion other risk weights may be also adopted to exposures to their sovereigns denominated in domestic currencies. We have also to remember that the category of sovereigns includes not only government and central bank but also other sovereign entities. The diversification of risk weights in prudential regulations for other sovereign entities is much higher than for government and central bank. All these remarks lead us to conclusion that existing system of risk weights is not completely flat. This is also the reason that any changes in this standard (making it more complicated and capital consuming) have to be broadly justified.

On the sources and channels of sovereign risk in the banking system

1. The brief review of past sovereign crises, the channels of this risk and the overall analysis of holistic role of sovereigns exposures included in the first 2 chapters of the BCBS paper are very important background for further discussion of this problem. However, it is of utmost interest to look at this issue from a wider perspective and not only concentrating on short time approach. This is the reason, why we would recommend to the policy makers not to draw simple conclusions from past crises. Historical references are useful but the prudential landscape has changed dramatically with the entry into force on the

regulatory reform after the 2007 financial crisis. Among many developments the mentioned below are crucial for us:

- a. The capital requirements for banks have significantly increased, including the role of instruments of the highest quality;
- b. New short-term liquidity and long-term liquidity requirements have been introduced;
- c. A more stable funding regime is being implemented;
- d. A new set of bail-inable instruments will (already do) enhance the loss absorbing capacity of banks across the world;
- e. Resolution plans are widespread in our banking sector.

These factors have to be taken into account in analyses of sources of possible new crisis in the future. After last crisis the banking system and regulators (for example through resolution methods) are much better prepared to manage future problems.

In our opinion, setting new requirements for banks it is important to have broader look at existing toolkit of instruments preventing and mitigating the potential crisis. We are convinced that - in comparison to the eventual problems in private sector - the potential sovereign crisis should be easier and quicker manageable because there are other prevention instruments in economic policy which can be used after occurring first signs of problems. The banking prudential regulations are important but they are not the only one and the best method to manage complex problem in public finance.

On the holistic role of sovereign exposures

2. We appreciate the approach of the BCBS in this chapter as it sheds light on the determinants of banks' holdings of sovereign exposures. In our opinion there is much misinformation about the reasons why banks hold sovereign exposures allegedly because of the financial crisis. There is a widespread bad publicity about banks' holdings of sovereign exposures that needs to be overcome.
3. Market making, liquidity management and regulatory compliance are today the main drivers of sovereign investments by banks. Government bond is virtually the only asset class eligible as Highly Quality Liquid Asset (HQLA) for the Liquidity Coverage Ratio (LCR). According to the latest data of the European Banking Authority (EBA), EU banks hold more than double of government bonds than before the crisis. This multiplication has permitted EU banks to increase significantly the LCR level.
4. It is important to note that stringent conditions for sovereign exposures could have unintended consequences for the economy, especially when the country is undergoing a

weak economic period, because debt issuance may be replaced with harder fiscal policies which may compound the problem of the economic downturn. Therefore, the regulatory treatment of sovereign exposures should be only part of a wider scheme.

5. The BCBS paper fails to consider the links between sovereign exposure and export credit business in corporate finance. In particular, banks in cooperation with Export Credit Agencies (ECA) can transform counterparty risk with sovereign risk. This has knock-on effect on the definition of central government entities (some ECAs sit within the government, others receive government support, others are Multilateral Development Banks). Any distinction on the risk-weight of local currency versus foreign currency exposures would also disadvantage such export financing, particularly when the exporting guarantee is from a jurisdiction other than the one of the loan's currency and may penalise any guarantee other than from a U.S. ECA (given the dominant role of USD for such export financing).

On the regulatory treatment and the potential ideas to change it

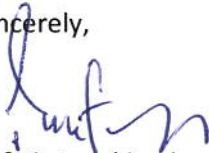
6. The standardised approach would introduce cliff effects which, in the case of sovereign exposures, could trigger abrupt market reactions. This would be the situation if the downgrading of a rating agency or the reclassification of a country in the OECD criteria trigger a significant increase in the capital requirement. Investors would crowd out thus exacerbating the problem.
7. The abovementioned problem bring us to the conclusion that an automatic Pillar 1 treatment, whatever its definition and calibration, is not a desirable solution for the treatment of sovereign exposures.
8. Another question is how to treat sovereign exposures in foreign currency. We would like to point out that subsidiaries of banking groups in third countries should treat their exposures in local currency according to the local currency rating and this should be the case at consolidated level as well.
9. Many local authorities do not have an external rating. New proposed prudential requirements for banks may mobilise these authorities to ask for external rating, but it is difficult to predict if the external ratings are more popular in the future. In other situation the lack of external rating may contribute to limited financing of local authorities by banks.
10. As regards concentration risk, we think that it is already sufficiently tackled by several prudential measures. In particular:

- a. Sovereign exposures are included in the leverage ratio which serves as the backstop measure in the scope of micro-prudential requirements.
 - b. The sovereign risk concentration is already monitored in recovery plans;
11. The minimum level of sovereign risk holdings in a bank is determined by the need to comply with the LCR and the NSFR. Therefore, it would be contradictory and detrimental to the functioning of the banking business to request a cost of capital to those mandatory investments. This is even more the case when the profitability of the banking system is consistently lower than in other sectors due, in part, to the significant increase of capital requirements.

CONCLUSION

Abovementioned comments bring us to the principal conclusion that no drastic changes in area of regulatory treatment of sovereign exposures should be made nowadays and the analysis of the factor pro and contra indicates some weak points of amendments in standardised approach for Basel III purpose. In our opinion the specific form of discussion paper, instead of traditional consultative document, also indicate that the Basel Committee members are careful to recommend the principal changes in the regulatory treatment of sovereign exposures.

Yours sincerely,



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President